Why We Don't Think a Market Correction Is Imminent

Capital-Markets Outlook—September 2014

Despite geopolitical tensions around the world and a brief sell-off in early August, the S&P 500 recovered and, during the month, passed the milestone level of 2,000. We discuss why we believe that the rally will continue and why current conditions differ in important ways from historical periods that preceded major corrections. Our Dynamic Asset Allocation service remains overweight equities.

Not Much of a Summer Swoon

During the last 10 years, equity markets have tended to wilt during the hottest months of the year—on average, by 7.9% for the S&P 500. Notable recent sell-offs in 2010 and 2011 (14.9% and 17.8%, respectively) were driven by concerns in the euro area. This year's summer swoon was relatively muted, however: a 3.9% descent from the S&P 500's mid-summer high on July 24 to its short-term trough on August 7. Late in the month, the S&P 500 pierced the 2,000 level, a number that is more symbolic than anything else but one that we wrote about in the summer of 2012.

Two years ago, amid broad pessimism, we concluded that the S&P could reach the 2,000 level in five to ten years. We were wrong ... it achieved that level in only two years. Signs that the eurozone crisis was becoming less severe, broad earnings growth, and stimulative monetary policy all contributed to the strong gains since that projection. We doubt that the next two years will be as good, but we continue to be optimistic, as many of the same tailwinds that drove recent returns are still present.

One tailwind is earnings growth. Many companies reported strong second-quarter results this month and gave forward guidance that reflected continued improvement in their businesses.

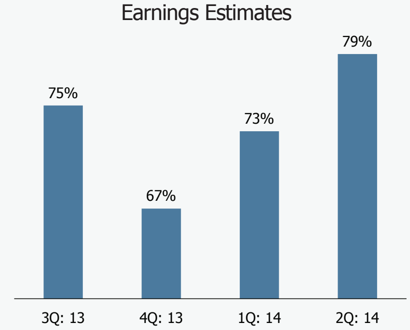
Impressive Earnings Reports

Through August 28, 486 companies in the S&P 500 had reported second-quarter earnings. The results are encouraging: 79% of these companies either met or beat consensus estimates; by this measure, it was one of the best quarters of the past five years and the best of the past year (*Display 1*). Healthcare services and healthcare products were among the sectors with the highest proportion of "meets and beats" in this period, while utilities and telecoms were among those with the lowest. It was a good quarter for revenue gains, as well, with 62% of S&P 500 companies meeting or beating consensus estimates for top-line performance—the best since the second quarter of 2012. Importantly, management teams and Wall Street analysts are becoming more optimistic. With greater confidence in underlying business trends, positive revisions to

Display 1

A Strong Quarter for Corporate Earnings

S&P 500 Companies Meeting or Beating Earnings Estimates

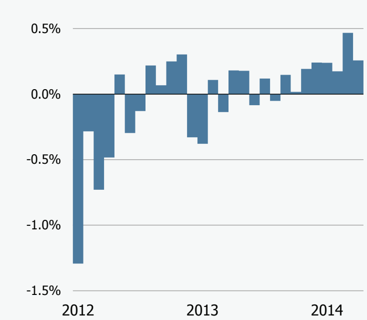


Source: FirstCall, SCB, AllianceBernstein

Display 2

Growing Business Confidence

S&P 500 Monthly Sales Revisions*



*Revisions/price, capitalization-weighted
Source: FactSet, SCB, AllianceBernstein

sales expectations have increased, as seen in Display 2 (*previous page*).

While US stocks performed very well in August, developed international stocks struggled because of economic weakness in the euro area and Japan. *(Display 3)*

Emerging-market equities continued to advance, hitting a three-year high on August 28 and rising 10.6% year to date. The reason is earnings: after three years of stagnation, earnings growth has been positive in the emerging markets this year.

The fixed-income market also rebounded in August, more than making up July's losses, as perceptions shifted to the view that central banks will remain accommodative for some time.

Real assets, however, trailed the overall equity market; commodity stocks and futures were relatively weak, as demand from China remained soft and as oil-related assets gave back some gains from earlier in the year.

While positive earnings reports and performance support our current overweight positioning in equities (highlighted below in our discussion of Dynamic Asset Allocation), they do not rule out a market correction. In fact, we have been saying that clients should expect more volatility in the intermediate term, due to the Fed transition to higher rates, ongoing geopolitical risks, and many other factors that could prove disruptive. That said, we do not expect a market correction in the near term.

Why a Correction Is Unlikely

Many previous equity corrections followed on the heels of excessive investor and corporate optimism. Although we've noted some signs of greater optimism on the part of corporate management, the current atmosphere is not overly buoyant: Hiring is improving but not excessive; M&A and IPO activity are up but largely concentrated in certain sectors; and, most important, many investors still do not believe the current rally can continue.

Valuations Are Reasonable

At the end of August, the forward P/E ratio for S&P 500 stocks was 15.6x. Although, viewed in isolation, this is toward the upper end of its historical range, it is not, in our opinion, cause for concern. Stock valuations should be viewed in the context of bond valuations. The forward earnings yield for stocks (forward earnings divided by price) is approximately 4% higher than the bond yield (represented by the 10-year Treasury). In past corrections, bond yields and stock earnings yields were, on average, closer to parity. The key point is that stocks are now significantly more attractive than bonds.

Rising Rates May Boost Stock Prices

While the Federal Reserve is expected to begin raising interest rates in 2015, we believe this is not likely to be negative for stocks.

Display 3

Major Markets Gain Ground

Index Returns

	2014	
	Aug	**Jan–Aug**
Stocks		
US	4.0%	9.9%
Developed-Market Int'l	-0.2	2.6
Emerging Markets	2.3	10.6
Bonds		
Municipal	0.7%	3.8%
Taxable	1.1	4.8
Alternatives		
Funds of Hedge Funds	N/A*	1.4%†
Real Assets	0.3%	7.5%

Past performance is not necessarily indicative of future results.
US stocks are represented by the S&P 500 Index; developed-market international stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Barclays US Aggregate Bond Index; and alternative investments by the Hedge Fund Research Inc.'s (HFRI's) Fund of Funds Composite Index. Real assets are represented by an equally weighted blend of MSCI ACWI Commodity Producers Index, FTSE EPRA/NAREIT Global Real Estate Index, and Dow Jones–UBS Commodity Index.
*The data are not yet available.
†Return from January through July
Source: Barclays, Dow Jones, FTSE, HFRI, Lipper, MSCI, and Standard & Poor's

Our research indicates that early in rate-hike cycles, equity markets generally rally and they tend to decline only after interest-rate policy is viewed as hurting future economic growth. In fact, when rates rise from very low levels, equity returns are at their strongest (*Display 4 next page*).

Conclusion

We believe that markets are not due for a significant equity correction at the present time. While we are mindful of rising optimism among investors and corporate leaders, valuations that are in line with long-term averages, and the likelihood of higher interest rates ahead, none of these signals is flashing red to us. In sum, we believe that this market rally has further to go.

Dynamic Asset Allocation Summary

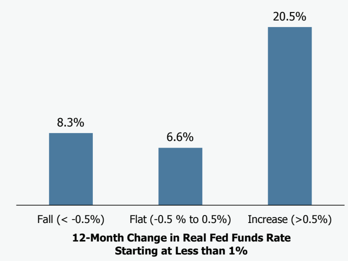
- We are maintaining an overweight in return-seeking assets with a focus on developed-market stocks, and we are underweight bonds.
- Measures of risk continue to be near historical lows.
- The fundamentals behind the equity overweight are solid: corporate balance sheets are strong, valuations are reasonable, growth expectations in the US continue to improve, and the expected return from bonds is diminished because of low yields.
- The possibility that rates will rise means that bonds may be less effective as a hedge against equity downside risk. We have incorporated other defenses—holding out-of-the-money equity-put options (where low stock-market volatility means that they are inexpensive) and hedging a selected basket of currencies against the US dollar.

The recommended allocation for a 60/40 private-client investor is a modest overweight to equities. As shown in Display 5, the weight to return-seeking assets is 63%.

Display 4

Rates Rising From Low Levels Are Not a Threat to Stocks

S&P 500 Performance



As of July 31, 2014

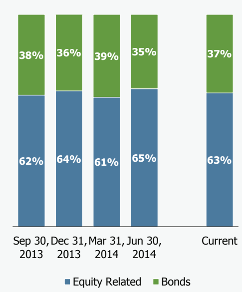
Historical analysis is not necessarily predictive of future results.

S&P 500 monthly total returns from Jan 1928 through Jul 2014.
S&P performance is the average monthly return multiplied by 12 for periods of falling, rising and flat real fed fund rates.
Real fed funds rate is the 3-month implied real rate from Jan 1920 through Jul 2014 (3-month nominal Treasury – YoY CPI change)
Source: Barclays POINT, Bloomberg and AllianceBernstein

Display 5

Maintaining an Overweight in Return-Seeking Assets

Asset-Class Weights



Current Positioning

Risk Decision:
- Overweight equities, underweight bonds

Diversification:
- Overweight developed-market stocks
- Neutral to emerging-market stocks

Defensive Strategies:
- Small equity put option position
- Hedging select currencies

As of August 31, 2014
Source: AllianceBernstein

The Capital Markets at a Glance

As of August 31, 2014	GDP Estimates 2014F (AllianceBernstein)	Stock Indices*: August 2014 Return (USD)	Stock Indices*: Year-to-Date Return (USD)	Stock Indices*: Price/Earnings Next 12 Months	Stock Indices*: August 2014 Dividend Yield
Global	2.7%	2.2%	7.2%	14.5x	2.4%
US	2.5%	4.0%	9.9%	15.6x	2.0%
Developed International**	1.4%	(0.2)%	2.6%	14.0x	3.1%
Emerging Markets†	4.3%	2.3%	10.6%	10.9x	2.7%

	Current	One Month Prior	One Year Prior
Yields			
US Effective Federal Funds Rate	0.09%	0.08%	0.07%
US Treasury, Three-Month	0.03%	0.03%	0.03%
US Treasury, Five-Year	1.63%	1.76%	1.62%
US Treasury, 10-Year	2.35%	2.58%	2.78%
Municipal Bond 1–10 Yr. Barclays Index	1.40%	1.51%	2.10%
Exchange Rates			
US Dollars per Euro	$1.32	$1.34	$1.32
US Dollars per British Pound	$1.66	$1.69	$1.55
Japanese Yen per US Dollar	¥103.89	¥102.84	¥98.12
Commodity Prices			
WTI Crude Oil ($/bbl)	$95.96	$98.17	$107.65
Gold ($/ozt)	$1,285.80	$1,281.30	$1,396.10
Economic Statistics			
US Unemployment Rate (*July 31, 2014*)	6.2%	6.1%	7.3%
US Inflation—CPI (*July 31, 2014*)	2.2%	2.4%	1.9%

Past performance is not necessarily indicative of future results.

**Stocks are represented by: Global—MSCI ACWI, US—S&P 500, Europe—Euro Stoxx 50, Germany—DAX, France—CAC 40, UK—FTSE 100, Japan —TOPIX 100, Developed International—MSCI EAFE, Emerging Markets—MSCI EM, China—SSE 180, India—India S&P BSE SENSEX, Russia—FTSE Russia, Brazil—Bovespa. S&P 500 returns are gross dividends reinvested. All other indices are net dividends reinvested. All returns are unhedged and reported in US dollars.*

***Countries are weighted by 2012 nominal GDP; not all EAFE countries are individually forecasted, and Canada is not included in the EAFE Index.*

†Countries are weighted by 2012 nominal GDP.

Source: Barclays, FactSet, MSCI, S&P 500, US Bureau of Labor Statistics, and AllianceBernstein

Disclosure About Dynamic Asset Allocation

There is no guarantee that the goals of the Dynamic Asset Allocation (DAA) overlay service will be achieved. An account invested in DAA may cause the account's overall exposure to equities, fixed income, real estate investment trusts (REITs), and other asset classes to vary significantly from the strategic long-term target allocations agreed upon for the account and may be different from information in this summary. Please read Bernstein's *Investment-Management Services and Policies* manual and the Prospectus for the DAA overlay portfolios for additional information about DAA, including the principal risks of investing in the DAA overlay portfolios.

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