AllianceBernstein

Winter 2011/2012

CAPITAL MARKETS OUTLOOK

Volatility Trumps Returns

As restless markets swamp fundamentals, it seems sensible to consider lower equity exposure. But there are still plenty of opportunities for active managers in both stocks and bonds…and the world economy continues to grow.

A Turbulent Year for Markets

As volatility goes, the fourth quarter saw a continuation of the dizzying gyrations that global stocks endured in 2011. However, the quarter's positive return did help reduce equity losses for the full year.

Many of the familiar concerns remained, including uncertainty about the outcome of Europe's financial troubles. There was widespread concern over the slowing economy in the euro area and the fate of the euro currency itself. Still, the global economy continued expanding in 2011.

Despite the slowdown in Europe, we're forecasting ongoing global growth in 2012, led by the emerging economies, particularly Asia. And, we're more positive on the prospects for the US economy than the consensus estimates.

Still Cautious in Equity Allocations

Our assessment of capital markets is much the same as it's been of late. Long-term fundamentals argue strongly for stocks' return potential, but volatility and risk aversion will be with us for a while. To us, this makes the case for underweighting stocks versus their strategic allocation targets until the market steadies itself.

Although we think stocks should be underweighted, we see opportunities that active management can uncover—including some that compensate investors for riding out market volatility. Investors might also consider substituting high-yield bonds for a portion of an equity allocation, a mix that has historically produced equity-like returns with less volatility.

Volatility warrants caution toward equities.

AllianceBernstein Capital Market Forecasts

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

AllianceBernstein Economic Forecasts

Real GDP Growth	2012F
Global	2.6%
Developed	1.5%
US	3.0%
EM	5.2%

Inflation	2012F
Global	2.7%
Developed	1.9%
US	2.6%
EM	4.6%

Forecasts may not be achieved.
As of January 3, 2012
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

The World Economy Continues to Grow

We think the world economic expansion will produce modest growth in 2012, despite lingering concerns about fiscal challenges and a weak economy in Europe. The US economy is showing signs of picking up strength.

European Anxiety: More of the Same

The failure of Europe's leaders to take decisive policy actions has caused government bond yields to soar. Meanwhile, the effort to reform national finances and introduce austerity measures is threatening the euro area's growth prospects.

If the euro area holds together, a number of scenarios could result from the possible policy mixes: these will likely fall somewhere along the continuum between recession and inflation. If there isn't much monetary stimulus to shore up economic growth, and if the focus on fiscal austerity intensifies, the tilt would be more toward a broad euro area recession.

Or, policies could emphasize more stimulus, with the European Central Bank injecting considerable additional liquidity into the economy—a move that could increase inflationary pressures. There's also the possibility that the euro bloc falls apart, creating an intense, acute shock that could push weaker countries into deep recessions. We think this outcome is unlikely.

Euro Area Economy Backslides

As this policy uncertainty continues, the area's economy has started to decouple from the rest of the world and is slipping into a mild contraction. The area's Composite Purchasing Managers' Index (PMI), which tracks the activity of euro area companies, rose slightly in December (though not shown in chart), but still lingered well below 50—considered the boundary between contraction and expansion. For the rest of the world, the Index stood at 50.8.

The weak outlook for the euro area economy is reflected in our estimates for growth in real gross domestic product (GDP), a common measure of economic output. While we expect to see growth of 1.6% for 2011, we see GDP contracting by about half a percent during 2012. The depth of the recession will be determined largely by policy decisions, although stronger growth in the rest of the world would also support the euro area.

Despite Worries, Global Growth Continues

There are worries beyond Europe. The economies of many emerging nations are slowing—in particular, some observers worry that China's important economy will suffer a hard landing—a sentiment we don't share. There are also political issues in many parts of the world, most recently Russia. The Arab Spring fueled concerns about the world's oil supply, anxiety that grew with Iran's recent posturing—and North Korea poses geopolitical risks.

In light of these big-picture concerns, it's no wonder that risk aversion is still extraordinarily high. But, despite some of the headline challenges, we still see the global economic recovery continuing. Based on our economic analysis, we're projecting that final global growth for 2011 will check in at 2.8%, and we see a similar 2.6% growth rate for 2012.

Asia should again set the pace, as nations like China, Indonesia, Malaysia and India find that falling inflation gives policymakers the flexibility to cut rates and stimulate growth. We expect China to continue its stimulus efforts, which should further support its balanced economy. While exports are still a big part of China's output, that country is also benefiting from higher domestic consumer spending and the ongoing construction of low-income housing.

The US Economy: Better Than You Might Think

Our 2012 forecast for US growth is decidedly more positive than the consensus and recent economic data have been exceeding analysts' estimates. Also, the Index of Leading Economic Indicators—a forward-looking metric with a strong history of forecasting coming economic conditions—signals more growth ahead.

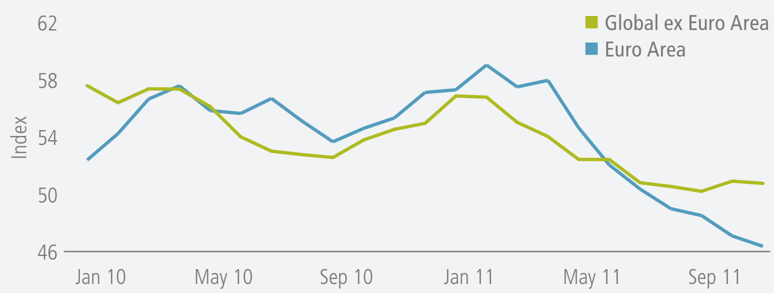
A "new mix" of capital expenditures and exports has contributed a much bigger share to US economic growth than in traditional recoveries. We expect capital expenditures to continue growing as businesses make up for sharp cutbacks. US exports, meanwhile, are well-balanced and should weather slower European demand. In 2010, exports to Italy, Spain, Portugal, Ireland and Greece combined accounted for less than 3% of total US exports.[1]

In addition to the continued support of these two drivers, we see ongoing signs of stabilization in consumption and housing—two drivers that have prevented a more robust recovery. Households have pared their debt burdens and cut payments sharply. This "deleveraging" has weakened spending so far, but consumption could continue to recover, especially if labor markets show further improvement.

Housing, a big reason for the downturn, could pick up, too. The formation of households is likely to recover toward more normal levels and housing demand should build—although from very low levels. We're already seeing some signs of recovery in rising new building permits.

A faltering euro area is decoupling from the world economy.

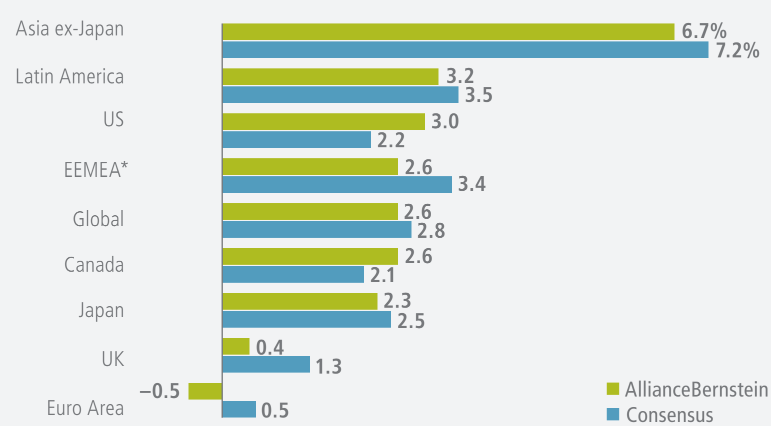
Manufacturing PMI



Historical analysis and current estimates do not guarantee future results.
As of December 1, 2011
Source: Haver Analytics and Markit

The world expansion should continue in 2012, led by emerging markets.

Percent Average Annual Rate 2012



Forecasts are subject to change.
As of January 3, 2012
*Eastern Europe, Middle East and Africa (including Hungary, Poland, Turkey, Russia, and South Africa).
Note: Consensus estimates are based on the latest available survey from November 2011.
Source: Consensus Economics and AllianceBernstein

[1]As of December 31, 2010. (Bureau of Economic Analysis and AllianceBernstein).

Prevailing Through Volatile Equity Markets

Risk aversion has put fundamentals on the back burner for now, but active managers can find a number of opportunities while investors wait for a return to normalcy.

Fundamental Frustration Continues

As we mentioned earlier, stocks seem relatively compelling based on long-term fundamentals. While yields on government bonds are well below their long-term averages, the returns we expect for stocks are in line with their long-term averages—and are dwarfing bond yields. We think this results in a healthy long-term "risk premium" for stocks.

But there's a lot of risk aversion in the air that hasn't cleared up yet. Our proprietary gauge of risk aversion shows a major shift in the perception of risk in recent years. Before the global financial crisis, it took seismic events like the collapse of Long-Term Capital Management or the Iraq War to jog the needle on risk aversion. Since the crisis, heightened risk aversion has stoked volatility and pressured riskier assets.

Historic Valuation Distortions

Differentiating between individual stocks has taken a back seat in this environment. It doesn't seem to matter how specific companies perform financially—we're seeing waves of risk-on, risk-off pileups that sweep most stocks along with them.

The market may be ignoring differences between stocks, but we're not. Based on our analysis, the gap between the valuations of the most expensive and cheapest stocks is almost as high as it's been in more than four decades. The price-to-book-value ratio for the most expensive stocks is about eight times the ratio for the cheapest stocks, a disparity exceeded only by the technology bubble.

This creates a very attractive environment for active equity managers who can use research to distinguish between good and bad stocks. This is the irony of today's market: risk assets are plagued by volatility and equities warrant an underweight, but there are really impressive opportunities within stocks.

Going Small Could Mean Big Opportunity

As we've been saying for some time, small- and smid-cap stocks represent one of those opportunities. And the unique character of this market segment magnifies the chances for really strong stock pickers to outperform.

Over the past decade, small caps and smid caps have outpaced the S&P 500 Index. These stocks typically include new, dynamic companies that may create substantial value for shareholders. But even though they've been outperforming for a long time, we think they still offer an opportunity for investors—as a strategic allocation.

Past return patterns suggest that it's very hard to time the performance of these stocks. Small-cap stocks have posted annualized returns of about 37% during historical small-cap bull markets. Missing out on only the single best month overall would have lowered that annualized return by 6%. Missing the five best months would have cost 20%, and without the 10 best months, annualized returns would have fallen to only 5%.

Whether we're looking at growth or value stocks, we think there's strong potential for active managers to outperform in this space—in part due to the relative lack of analyst coverage. We also think that global research is vital to understanding these companies in an increasingly global economy.

In Search of Dividend Payers

Long-term, fundamental opportunities won't truly be recognized and rewarded by the market until risk aversion fades. In the meantime, some equity strategies—dividend-paying stocks, for example—can provide important benefits.

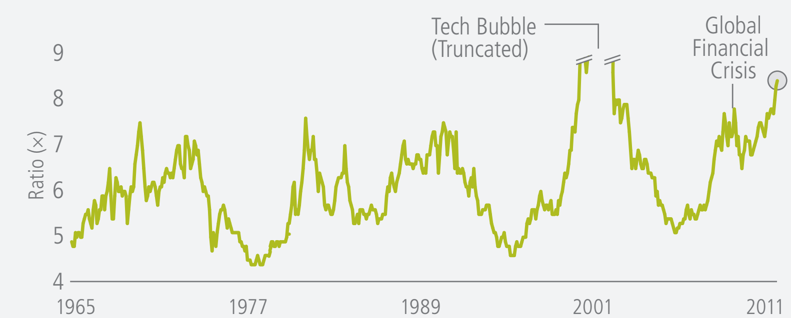
With Treasury yields driven so low by a flight to safety, the dividend yield on the S&P 500 Index now matches the yields on 10-year Treasury bonds.[1] This is rare—having happened just one other time in the last half century (when the market bottomed in 2008/2009)—because equity investors usually sacrifice some relative yield in order to access bigger potential price gains. Dividends also tend to grow: over nearly four decades, the annualized growth of dividends for the S&P 500 Index has exceeded inflation.[2]

Some may believe that equity-income stocks are a crowded trade today, but we feel strongly that a bottom-up active manager can build a portfolio with high dividends and compelling valuations.

This isn't a simple task. Sometimes a high dividend yield stems from the depressed stock price of a troubled company that hasn't cut its dividend yet. Historically, the highest-yielding 20% of stocks hasn't been the best-performing group; the next 20%, which is generally of higher quality, has that distinction. This same group has also been more resilient during troubled times—such as the global financial crisis of 2007 and 2008.

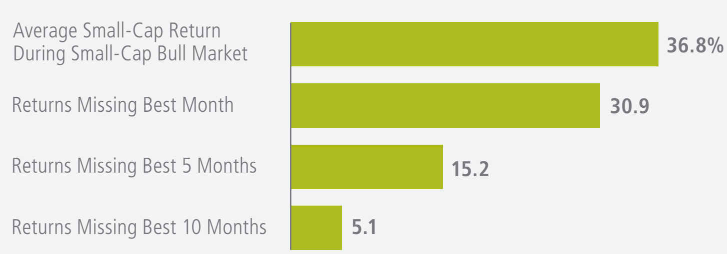
Value distortions have risen to historic levels.

Global Equities Q5/Q1 Price/Book Spread*



Historical analysis does not guarantee future results.
Through December 31, 2011
*Global developed large-cap stocks; represents the ratio of the most expensive quintile to the least expensive quintile of stocks. To provide a clear context on current equity valuation levels, data have been truncated to exclude the peak of the Internet bubble, when valuations surged to extreme levels. Individuals cannot invest directly in an index. Please see the back cover for index definitions.
Source: Center for Research in Security Prices, Credit Suisse, MSCI and AllianceBernstein

To avoid missing performance bursts, allocations to smaller stocks should be strategic.



Historical analysis and past performance does not guarantee future results.
As of September 30, 2011
Individuals cannot invest directly in an index. Please see back cover for index definitions.
Source of historical returns: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago, used with permission. All rights reserved. www.crsp.uchicago.edu. The performance has been calculated by BofA Merrill Lynch Small Cap Research. All rights reserved.
Source: BofA Merrill Lynch Small Cap Research, CRSP, Russell Investment Group; and AllianceBernstein

[1]As of December 31, 2011. (Bloomberg, Standard & Poor's, US Treasury and AllianceBernstein).
[2]As of December 31, 2011. (Bureau of Labor Statistics, Standard & Poor's and AllianceBernstein).

Bonds and Real Assets: Diversification and Potential

Real assets may provide insulation against inflation pressures, which we think are inevitable. Bonds can do much more than counterbalance stocks—they can also help de-risk equity exposure itself, and add valuable sources of return potential.

Facing the Inflation Threat

The wave of growth-friendly steps taken by policymakers in many parts of the world is a reminder that in an unpredictable world, inflation shocks are always possible. And they can do real damage to investors' portfolios.

For example, an investor who retired in 1972 would have seen annualized inflation of 9% over the ensuing 10 years, with a 60% stock/40% bond portfolio losing 3.5% in inflation-adjusted annualized returns.[1] Of course, the inflation of the 1970s may be an extreme example, but even a less severe inflationary period can hurt, and we have strong reason to believe that inflation pressures will re-emerge ahead.

There is no silver bullet to protect investors from inflation: different assets thrive in different environments. In past low-growth/low-inflation environments, natural resource and real estate stocks have provided the best return potential, while commodities trailed even the broader stock market. In high-growth/high-inflation times, commodities have won the day while real estate and natural resources stocks have beaten diversified equities. We think this supports an active approach that dynamically shifts assets among a number of "real" assets.

High Yield: An Equity De-Risker?

In addition to seeking inflation protection, investors might also consider ways to temper the risk of their equity allocations. A seemingly unlikely candidate could be high-yield bonds. Historically, high yield has offered equity-like return potential: since 1983, it's produced an annualized return of 9.3%, near the equity return of 10%. But high yield has displayed about half the volatility. This pattern of better risk/reward has been even more pronounced since 2007.

Below-investment-grade bonds have also shown a low correlation to other investment types. This makes a strong case for high yield to have its own seat at the asset-allocation table—in this case, as a lower-volatility enhancement to investors' remaining equity exposure.

Today, even though corporations are producing strong profits and cash flows, risk aversion has boosted the risk compensation high-yield investors demand—yields that are 7% higher than those of Treasuries. In addition to attractive yields, there's also the potential that a decline in risk aversion could shrink that risk premium, boosting high-yield prices.

High Yield Municipals Are Still Inexpensive

Municipal high-yield bonds are also attractive. They offer 5% more yield than the highest-quality 10-year AAA-rated municipal bonds—much higher than the historical average of 3%.[2] Throw in the fact that AAA-rated munis already out-yield Treasuries at most maturities—even before accounting for munis' tax advantages—and the case for muni high yield is strong.

The muni yield curve is very steep, with intermediate yields much higher than short-term yields. As intermediate-term bonds age, they gradually become shorter-term bonds that pay higher income than other short-term bonds. This tends to make the bond more attractive, and its value can rise because of it. Actively managing this "roll" is just one factor in managing bonds, but we think it's a potent factor today.

[1]Past performance is no guarantee of future results. Stocks are represented by the S&P 500 (with a Global Financial Data extension) and bonds by 10-year Treasuries. Inflation is measured by US CPI, US City Average, all items, not seasonally adjusted, through December 2010. An investor cannot invest directly in an index. Please see back cover for index definitions. (Global Financial Data, US Bureau of Labor Statistics and AllianceBernstein).

[2]As of December 23, 2011. (Municipal Market Data Corp. and AllianceBernstein estimates for AAA-rated, callable municipal bonds).

Getting More from High-Grade Bonds

Opportunities to roll down the yield curve are also available in global high-grade bonds, given the shape of yield curves in many countries. We think a global approach to bonds makes sense for several reasons. For one, globalizing a bond portfolio can help reduce its direct exposure—and sensitivity—to interest-rate changes in a single-home market.

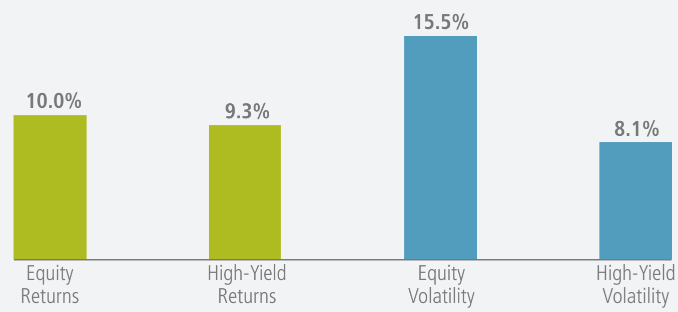
Economic cycles aren't synchronized across countries, and neither are the related interest-rate movements. As a result, no one country wins all the time. The UK, for instance, was the worst performer among major developed bond markets on a currency-hedged basis in 2006, before gradually rising to the top by 2010. In 2011, most markets produced positive returns, in part because of the global flight to quality. Even the beleaguered euro area finished up, despite being dragged down by weak peripheral countries.

Active managers can also strive to add value by adjusting country exposures, seeking to take advantage of strong bond markets and to reduce the impact of weaker ones. The size of the opportunity can be seen in the gap between the best and worst bond markets in a given year: in 2011, the UK returned 15.8% while Japan eked out 2.5%.

When it comes to a global core bond portfolio, we think the best approach is a currency-hedged strategy that protects against what could be the overwhelming impact of currency volatility compared with that of bonds.

High-yield bonds have produced equity-like returns with much lower risk.

Historical Performance, July 1983–November 2011



Historical analysis and current estimates do not guarantee future results.
Equity represented by S&P 500, High Yield represented by Barclays Capital US Corporate High Yield Index. Individuals cannot invest directly in an index. Please see the back cover for index definitions.
Source: Barclays Capital, Standard & Poor's and AllianceBernstein

Bond returns vary significantly across countries and cycles.

Fixed-Income Country Returns Percent, USD Hedged*

	2006	2007	2008	2009	2010	2011
Best	Japan 5.3	US Treasuries 9.0	Australia 15.1	Euro Area 4.1	UK 7.2	UK 15.8
	Canada 4.6	Japan 7.8	US Treasuries 13.7	Japan 1.4	US Treasuries 5.9	US Treasuries 9.6
	US Treasuries 3.1	Canada 5.7	Canada 11.7	UK –1.6	Canada 5.6	Australia 8.4
	Euro Area 1.8	UK 4.7	UK 10.4	Canada –1.9	Japan 2.9	Canada 8.2
	Australia 1.2	Euro Area 3.1	Euro Area 8.4	US Treasuries –3.6	Euro Area 1.0	Euro Area 2.6
Worst	UK 0.9	Australia 2.0	Japan 6.7	Australia –5.9	Australia 0.3	Japan 2.5
Gap between best and worst	4.4	7.0	8.4	10.0	6.9	13.3

Past performance and current analysis do not guarantee future results.
As of December 28, 2011
*These returns are for illustrative purposes only and do not reflect the performance of any fund. Diversification does not eliminate the risk of loss. Returns represented by respective Barclays Capital country bond indices. Investors cannot invest directly in an index. Please see back cover for index definitions.
Source: Barclays Capital, Bloomberg, Haver Analytics, National Accounts, US Department of the Treasury and AllianceBernstein

Your investments are important to you—they're your means of reaching your financial goals and achieving better outcomes in life. At AllianceBernstein Investments, we're committed to putting our research to work for you:

- 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

Our research insights are a foundation to help investors build better outcomes. Speak to your financial advisor to learn how we can help you reach your goals.

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