AllianceBernstein

Winter 2010/2011

CAPITAL MARKETS OUTLOOK

Opportunities in the Ongoing Recovery

The global economy appears poised for continued growth in 2011. Research-driven active investors should find opportunities in both stocks and bonds—with stocks somewhat more compelling, in our view.

More Potential in Stocks than in Bonds

Capital markets took investors on an eventful ride during 2010, but in the end, the trip was worthwhile. Equities produced strong returns globally and bonds had a solid year, despite late headwinds as interest rates began to rise in the US and other markets.

In our view, equity markets offer somewhat more potential than bonds do in 2011. We believe stocks are like a coiled spring, held down by worry and uncertainty over issues including government regulations, but with the underlying potential of abundant stimulus and potential job improvements. We feel the influence of high-level macro issues on stock returns will lessen, and that security selection will regain its prominence in determining investment success.

Global Growth Should Continue

Based on our economic assessment, fiscal and monetary stimulus efforts will gain additional traction in moving the world economy forward. We're seeing measurable improvement in employment in key developed nations, and consumers seem to have grown more willing to spend money—despite surveys that indicate low confidence.

We expect the global economy to expand by 3.5% in 2011 based on real, or inflation-adjusted, gross domestic product (GDP)—a measure of overall economic output. We've recently raised our growth projections, with emerging market demand and new US stimulus driving the expansion. The euro area, despite persistent worries about sovereign debt woes, should gain a modest amount of momentum.

We expect emerging markets to drive global growth again in 2011

AllianceBernstein Economic Forecasts

Real GDP Growth	2010F	2011F
Global	3.9%	3.5%
Developed	2.5%	2.7%
US	2.9%	3.8%
EM	7.4%	5.5%

Inflation	2010F	2011F
Global	2.3%	2.4%
Developed	1.4%	1.6%
US	1.7%	2.0%
EM	4.9%	4.5%

AllianceBernstein Capital Market Forecasts

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

Forecasts may not be achieved.
As of December 31, 2010
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

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The World Economy Continues to Expand

The global expansion should continue into 2011 with emerging economies leading the way. We see some encouraging signs on the employment front and from consumer spending, but there are also risks that require vigilance.

Avoiding the Double Dip

The world economy is producing above-trend growth: once the final tallies for 2010 are in, we expect global real GDP will have grown by 3.9%. That rate is consistent with our forecasts throughout the year—in fact, consensus estimates, which had called for slower growth, have gradually risen toward our projections. It appears likely that the global economy will avoid the dreaded "double dip," in line with our outlook.

The pace of expansion will moderate; our projections call for real global GDP growth of 3.5% in 2011, with sizable contributions from the new US stimulus and demand from emerging markets. Emerging economies should continue to drive the recovery, with China, India and Brazil leading. In Asia ex-Japan, manufacturing has bounced back from a summer slowdown, and we expect stronger industrial and export activity in these economies. In Brazil, production paused in the third quarter, but a number of indicators show voracious consumer demand.

Relatively strong growth and continued loose monetary policy have fueled inflationary pressures in a number of emerging economies. We anticipate that policy makers will be largely successful in using both traditional and nontraditional means to prevent their economies from overheating.

US Should Outpace Developed Europe

We expect developed economies to exhibit slower growth than emerging economies. However, manufacturing activity appears to be rising, and even the sovereign debt crisis couldn't prevent the euro area from gaining momentum—driven largely by economies such as Germany.

We've increased our US growth forecast for 2011. We believe stronger activity will be driven mainly by a new mix of exports as well as accelerated capital spending to meet growing emerging market demand and respond to the year-end stimulus package. The US economy has continued to expand even as consumers haven't contributed their usual momentum.

US Consumers Spend…Are More Jobs Around the Corner?

Consumers, however, may be getting ready to assume a bigger role in driving economic growth. US households are in better financial shape: their debt burdens are lower, while their income, net worth and personal savings are improving or considerably higher. Surveys show a lack of confidence, but spending appears on the upswing anyway. Results from the holiday shopping season are encouraging, with consumers opening their wallets and pocketbooks more than in recent years.

Their spirits could be lifted by the extension of the Bush tax cuts—which keep more money in the hands of US households—and unemployment insurance. The government hopes that consumers will spend these funds. For instance, there's substantial pent-up demand in big-ticket consumer items, such as autos, where activity has been well below normal in recent years.

An improvement in the jobs picture would be a big confidence booster in the US and elsewhere. Headline unemployment remains high at 9.4% in the US, 10.1% in the euro area and 7.8% in the UK, but there are signs of improvement in key markets like Germany and the US.[1] New jobless claims in the United States, for instance, have fallen to the lowest level since May 2009, and more temporary jobs hint at better job creation down the road. This outlook is bolstered by corporate CEO hiring plans for the next six months, which recently hit multi-year highs.[2]

[1]US as of November 2010; Euro area as of October 2010 and UK as of September 2010. (Haver Analytics).
[2]Jobless claims as of January 6, 2011. CEO outlook as of December 17, 2010. (Business Roundtable, Department of Labor and Haver Analytics).

Inflation, Deficits Are Among Key Risks

Given the slack in developed economies, we're not overly concerned about continued growth stoking inflation in those countries. But there are risks in the extremely low interest rates in many economies as well as the US Federal Reserve's second quantitative easing plan ("QE2" for short).

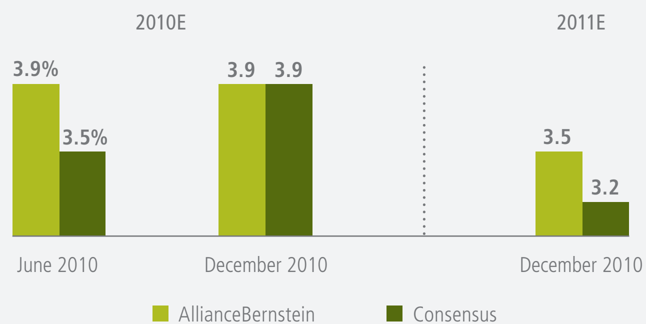
As the Fed buys long-term Treasury bonds and pours more cash into the system, it's boosting an already growing economy. Reversing this stimulus too soon could cool the economy too much, while maintaining it too long could cause overheating. Capital markets had already priced in QE2, and interest rates rose ahead of the year-end tax package as analysts increased US growth forecasts.

It will take hard choices to resolve the yawning budget gaps in the US and other developed nations. Europe has already made some painful decisions as it addresses its sovereign-debt crisis. We think this issue will ebb and flow throughout 2011, with the European Central Bank (ECB) acting as a circuit breaker if there's a threat to larger economies and the banking sector.

In emerging economies, inflation is more of an issue—and higher prices could eventually affect developed economies through global trade links. Policy makers are using an array of approaches to rein in prices: in China, for example, banks are being required to hold more funds in reserve. Concern over inflation has led some investors to consider allocations to commodities and inflation-protection strategies to insulate their portfolios.

The 2010 consensus global growth estimate has converged with our projection

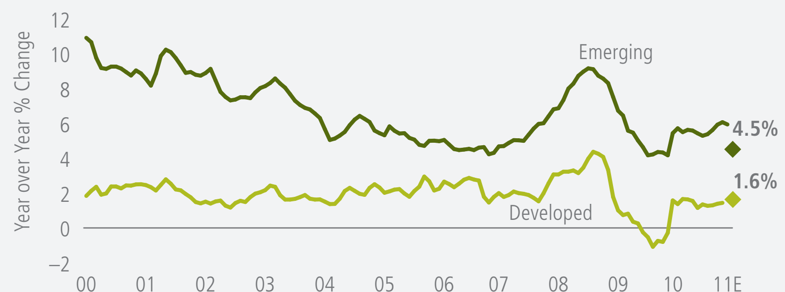
Global Real GDP Growth Forecasts



Forecasts may not be achieved.
As of December 31, 2010
Source: AllianceBernstein

Inflation is more of a concern in emerging economies

Global Inflation Rate



Historical analysis and current estimates do not guarantee future results.
Actual as of November 30, 2010. 2011 estimates as of December 31, 2010
Source: Haver Analytics, National Accounts, World Bank and AllianceBernstein

Our View: Global Stocks Have More Room to Run

Stocks have bounced back dramatically, but still don't fully reflect the potential we see—particularly for active investors. In our view, bonds offer less potential right now, but intensive research can uncover opportunities in the municipal and taxable markets.

Equity Markets Have Been Choppy but Resilient

Stocks haven't exactly been the destination of choice the past few years, even as they've managed to battle through choppy periods to climb most of the way back from their previous depths. In the US, investors pulled $124 billion from equity funds between March 2009 and October 2010, while pouring $227 billion into bond funds.[3]

Nonetheless, the equity rebound highlights the ability of stocks to be fairly resilient, even after severe setbacks. Global stocks, as measured by the MSCI All-Country World Index, reached bottom in early 2009; since then, they've risen more than 80%.[4] Stocks actually began their long journey back quite some time before the global economy lifted itself back onto its feet—a relationship that's backed up by historical experience.

Potential Still Present in Equity Markets

While it's understandable that investors are fretting about the possibility of another economic and market slump, they shouldn't overlook the return potential that we believe remains in equities. Corporate profits are strong, and so are balance sheets—with ample cash stockpiles that companies may deploy in shareholder-friendly activities like stock buybacks and dividend increases. In our opinion, the key to identifying these companies is in-depth, active research.

As we mentioned earlier, stocks today seem like a coiled spring. The weight of investors' anxieties, uncertainty about the impact of government regulations and policies, and pent-up spending from individuals and businesses are holding markets down. At the same time, the prospects of a return to greater risk taking, improved job growth and renewed capital spending could lift that weight and push markets higher.

That upside is reflected in the returns that global stocks could achieve over the next five years. If earnings grow by 8% annualized over that time (a reasonable assumption), equities might return almost 65% cumulatively. There could be still more upside if companies, which have been hoarding cash, return to paying out a typical proportion of their earnings to shareholders as dividends.

If investors also become willing to pay more for each dollar of earnings that companies are generating, as measured by the price-earnings ratio, it could further increase the potential in stocks. If both dividend-payout ratios and price-earnings ratios rise toward to their historical norms over the next five years, the possible cumulative return might be closer to 85%.

Emerging equity markets have already started to recognize strong earnings power: even as money flowed out of categories such as large-caps, emerging market stocks enjoyed heavy inflows and stellar returns of nearly 27% over the last six months.[5]

Even after this impressive run, we don't see valuations as stretched. The price-to-earnings ratio shows that emerging market stocks are still trading at a meaningful discount to developed market stocks—despite greater profitability and growth prospects.

[3]As of October 31, 2010. (Strategic Insight).
[4]**Past performance is no guarantee of future results.** As of December 31, 2010. An individual cannot invest directly in an index. Please see back cover for index definitions. (MSCI and AllianceBernstein).
[5]**Past performance is no guarantee of future results.** As of December 31, 2010. An individual cannot invest directly in an index. Please see back cover for index definitions. (MSCI and AllianceBernstein).

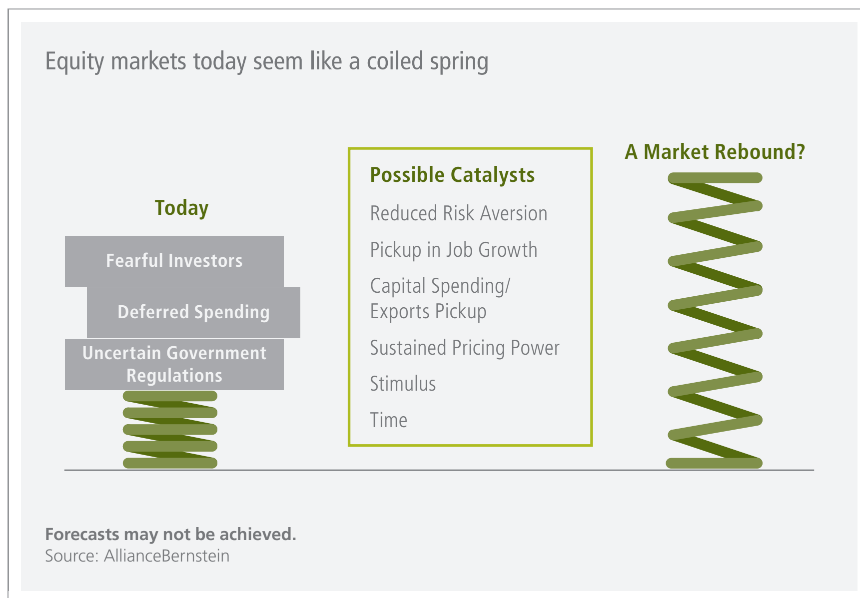
Active Stock Picking to Be Rewarded

Based on our analysis, the opportunity to add value by selecting individual stocks is still unusually high across the global equity universe—and could add further to stock returns as we move forward.

Stocks have moved up and down together to a remarkable extent over the last couple of years, even though there are big differences between the financial strength of individual companies. This herd-like environment has frustrated investors who seek to outperform by applying a research-driven approach to picking individual stocks.

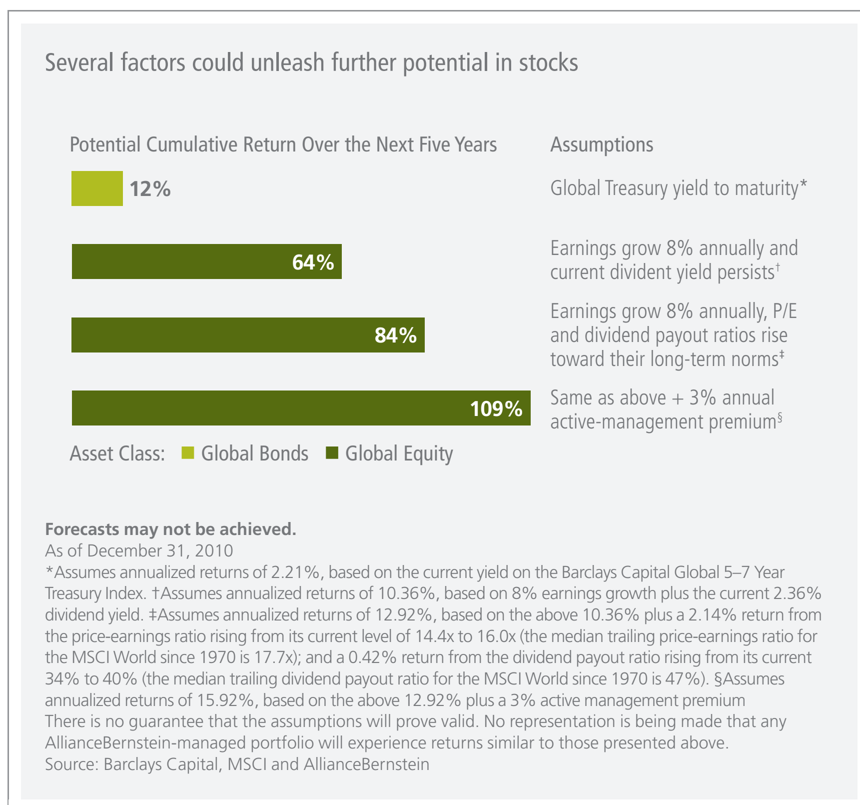
However, history shows that over the long run, individual companies' financial performance ultimately does make the biggest difference in equity returns. We believe that over time, the market's fixation on high-level macro factors such as the economy, regulations and politics will begin to fade.

As this happens, we're convinced that investors will start looking with greater scrutiny at how individual companies stack up. In that type of environment, stock selection is likely to return to its place as a driver of outperformance for investors. And, investors who can distinguish between the winners and losers will reap greater rewards.



Equity markets today seem like a coiled spring

Forecasts may not be achieved.
Source: AllianceBernstein



Several factors could unleash further potential in stocks

Forecasts may not be achieved.
As of December 31, 2010
*Assumes annualized returns of 2.21%, based on the current yield on the Barclays Capital Global 5–7 Year Treasury Index. †Assumes annualized returns of 10.36%, based on 8% earnings growth plus the current 2.36% dividend yield. ‡Assumes annualized returns of 12.92%, based on the above 10.36% plus a 2.14% return from the price-earnings ratio rising from its current level of 14.4x to 16.0x (the median trailing price-earnings ratio for the MSCI World since 1970 is 17.7x); and a 0.42% return from the dividend payout ratio rising from its current 34% to 40% (the median trailing dividend payout ratio for the MSCI World since 1970 is 47%). §Assumes annualized returns of 15.92%, based on the above 12.92% plus a 3% active management premium
There is no guarantee that the assumptions will prove valid. No representation is being made that any AllianceBernstein-managed portfolio will experience returns similar to those presented above.
Source: Barclays Capital, MSCI and AllianceBernstein

Municipal Bonds: More Support than Meets the Eye

When US investors pulled $2.4 billion from bond funds in November, it broke a streak of nearly two years during which bonds seemed to be the darling of investors worldwide—a shelter from the higher volatility of stock markets.[6]

Much of November's outflow came from municipal bond funds for a number of reasons. Treasury bond yields rose—and prices fell—as better economic data and expectations of stronger growth circulated. This pushed up yields broadly across fixed-income markets, including municipal bonds. Temporarily heavy bond issuance by state and municipal governments also put upward pressure on municipal bond yields, and investors remained on edge as a flood of media reports circulated about the budgetary headwinds facing certain municipalities.

We think there's more support for municipal bonds than meets the eye. Tax revenues have rebounded sharply since the economic downturn, rising in each of the first three quarters of 2010. Meanwhile, the estimated budget gaps for fiscal year 2012 are similar to the holes filled this past summer—and less than half the size of the gaps addressed the previous summer.[7]

State and local governments certainly face hard choices in making ends meet, but they have the tools to do it. As these efforts take shape, it will take skilled active management to identify the states and localities that will be most successful in using these tools—and those that will falter.

Opportunities in Global Bonds

In taxable bond markets, where inflation-adjusted yields on government bonds in many developed economies are still low, investors have sought opportunities in other sectors. Corporate bonds, for example, typically offer incrementally higher yields, or yield "spreads," compared to government bonds, compensating investors for added credit risk.

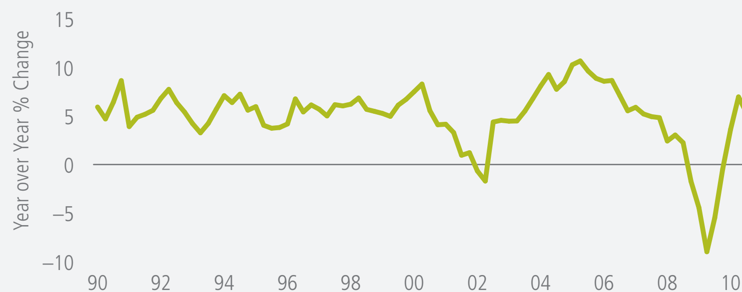
While credit spreads have fallen substantially from their financial-crisis levels, they're still modestly above long-term averages, providing an attractive risk-reward trade-off for investors. Non-government bonds offer opportunities even in certain countries that might seem "too risky" on the surface.

For example, among weaker euro-area countries such as Spain and Italy, the pricing of derivatives that protect against bond defaults suggests that some corporate bonds are perceived as less risky than their home government's bonds. Of course, it takes careful research and investing to identify and capture these opportunities in a diversified fixed-income portfolio.

More broadly, as the risk of rising interest rates and inflation weigh on bond markets, investors are considering strategies to position their bond portfolios accordingly. Intermediate-term strategies tend to be better equipped than long-term bonds to weather rising rates. Inflation-protected bond strategies can provide insulation against rising prices, as can strategies that invest in real assets like commodities and real estate.

State tax revenues have bounced back as the economy has recovered

State and Local Government Tax Collections



Historical analysis does not guarantee future results.
As of September 30, 2010
Source: Bond Buyer, Bureau of Economic Analysis, Municipal Market Data Corp., Yield Book

[6]As of November 30, 2010. (Strategic Insight).
[7]As of December 2010. (Center on Budget and Policy Priorities).

Sticking to a Long-Term Strategy Can Help

It wasn't easy to keep a portfolio on track through the downturn, but a carefully maintained, balanced strategy could have regained a lot of lost ground. Looking ahead, stocks appear more attractive than bonds.

Bouncing Back from the Bottom

When stocks plummeted in 2008 and early 2009, many investors endured major losses in their equity holdings. Someone investing $10,000 in a portfolio of 60% stocks and 40% bonds and rebalancing monthly to maintain those allocations might have seen that investment fall to just over $6,300 by February 2009.

For some investors, the experience shattered their confidence in stocks, and they fled to low-yielding safe haven investments that provided shelter from tumultuous markets. But stocks have turned things around since that low point: by the end of 2010, they had climbed much of the way back to their previous peak. An investor who stayed the course with that 60/40 portfolio could have seen the portfolio's value rebound to almost $9,700 by the end of 2010.

Of course, it's important to work with your financial advisor closely to make sure that your portfolio design makes sense for you, based on your specific long-term financial goals and tolerance for risk.

You may also find it helpful to adjust your course settings modestly from time to time with temporary modifications to your long-term portfolio allocations. The goal isn't to head full throttle for what seem to be the best asset classes at a given time but to navigate carefully, avoiding particularly choppy seas.

Stocks More Compelling than Bonds

As we survey global capital markets at the end of 2010, we see stocks as offering a modestly better risk-reward trade-off than bonds. Global equity valuations remain compelling, the economic recovery is broadening and the outlook is strong for corporate profits. For bonds, interest rates in many countries are still low, although rising rates have boosted yields in some markets, including the US and some European countries.

In both asset classes, we believe that active management is best-suited to uncover the securities that offer the greatest potential. And a carefully managed, long-term strategy can help investors navigate through ever-present risks, pointing the way to opportunity.

Maintaining a balanced portfolio might have helped investors recover

Growth of $10,000 (60% stocks/40% bonds*)

Past performance is no guarantee of future results.
As of December 31, 2010
*This is a hypothetical example.Stocks are represented by the MSCI World Index and bonds by the Barclays Capital Global Aggregate Bond Index. An individual cannot invest directly in an index. Please see back cover for index definitions.
Source: Barclays, MSCI 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

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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Index Definitions: The **MSCI World Index** is a market capitalization–weighted index measuring the performance of stock markets in 23 countries. The **MSCI All Country World Index** is a market-capitalization–weighted index measuring equity market performance of developed and emerging markets. The **MSCI Emerging Markets Index** measures equity market performance in the global emerging markets. The **Barclays Capital Global 5–7 Year Treasury Index** tracks fixed-rate local currency sovereign debt of investment-grade countries in the 5–7 year maturity range.

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