AB BERNSTEIN

Highs and Lows

Capital-Markets Outlook—December 2014

Calm returned to stock and bond markets in November after a burst of volatility earlier this fall, but the return advantage of US stocks to non-US stocks widened as the dollar strengthened. We continue to overweight both US and non-US developed-market stocks and to underweight bonds. Given the recent plunge in oil prices to a multiyear low, this month we're providing a Focus on Oil.

Volatility for stock and bond markets fell back below average in November. Year-to-date returns were positive for most major market indexes, with US stocks far in the lead (**Display 1**).

Both the large return advantage for US stocks versus non-US stocks and the US dollar's 9.5% gain this year reflect the accelerating economic recovery and strong corporate earnings growth in the US, as well as weakness in Japan, Europe, and China.

Recent data show that Japan has slipped back into recession in the wake of a sharp tax hike in April. The European Union is struggling to maintain positive aggregate growth. With bond yields still at very low levels, bond market returns were up modestly in November and positive for the year.

Returns for real assets were down in November and year to date, with strong gains in real estate more than offset by losses in commodities. The price of oil has fallen nearly 35% from its mid-June high. (See Focus on Oil on page 3.)

The Case for International

For many US investors, the very weak returns from stocks in non-US developed markets relative to US stocks this year is frustrating. The S&P 500 Index of large-cap US stocks has outperformed the EAFE Index of developed non-US stocks in five of the seven periods shown in **Display 2, next page:** The S&P 500 is purple; EAFE is dark blue. (Note: EAFE returns were better before being translated into US dollars.)

But non-US stocks, like US stocks, are unusually attractive today versus bonds—and may outperform US stocks in the future, as they have at times in the past. EAFE outperformed the S&P 500 from 2002 through 2007; in 1993 and 1994; and from 1983 through 1988.

In a few of those years, EAFE returns were roughly 20 percentage points higher than the S&P 500's returns. In 1986, EAFE led by a whopping 50 percentage points, propelled by a historic plunge in the dollar.

Display 1

US Stock Leadership Widened

Index Returns in US Dollars

	2014	
	Nov	**Jan–Nov**
Stocks		
US	2.7%	14.0%
Developed-Market Int'l	(1.3)	(1.5)
Emerging Markets	1.4	2.5
Bonds		
Municipal	(0.4)%	4.0%
Taxable	0.7	5.9
Alternatives		
Funds of Hedge Funds	N/A*	1.9%**
Real Assets	(3.2)%	(3.0)%

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; alternative investments by the Hedge Fund Research Inc.'s (HFRI's) Fund of Funds Composite Index; and real assets by an equally weighted blend of MSCI ACWI Commodity Producers Index, FTSE EPRA/NAREIT Global Real Estate Index, and Dow Jones–UBS Commodity Index. See "Information About MSCI" at the end of this report.
**The data are not yet available.*
***Return from January through October*
Source: Barclays, Dow Jones, FTSE, HFRI, Lipper, MSCI, and Standard & Poor's

Emerging-market stocks (olive in Display) have also outstripped and lagged US stocks at various points. Small-cap stocks (dark green) have beaten large-cap stocks—and been beaten by them.

And bonds have outperformed stocks at times, as they did in September and October—and much more dramatically in 2008 and early 2009. Remember?

Diversifying across all these asset classes (and others) allows investors to get higher returns over time with far less volatility than any one would provide and widens the opportunity set. The downside of diversifying, of course, is that you always have exposure to whatever asset class does worst.

On its own, sustained US stock market leadership might suggest that non-US stocks are due to take the lead. You might even think that we should tilt to non-US developed over US stocks.

We're not doing so, because our Dynamic Asset Allocation process reflects a much more complex balancing of risk and return potential. While developed-market stocks outside the US are now more attractively valued than US stocks, US stocks have the advantage from a risk perspective (**Display 3**).

Dynamic Positioning

Our Dynamic Asset Allocation service retains a modest overweight in return-seeking assets (**Display 4**), with a focus on developed-market stocks, proportionately allocated to US and developed non-US stocks.

The equity overweight reflects both fundamentals and policy considerations. Strong corporate balance sheets and earnings trends offset slightly rich global equity valuations. Bond yields remain very low, but will likely rise next year in the US.

The Bank of Japan has begun a dramatic increase in its bond-buying program. The European Central Bank has announced that it will do the same soon. These measures outweigh the reduction in stimulus by the US Federal Reserve and encourage risk-taking.

These policy considerations support our modest overweight in return-seeking assets and make us cautious about currency exposure. We have hedged a basket of currencies against the dollar, particularly the yen. We've hedged about one-eighth of the exposure to non-US currencies that most diversified clients have from their non-US holdings.

Display 2

No Market Always Wins

Major Stock Indexes' Annualized Returns in US Dollars

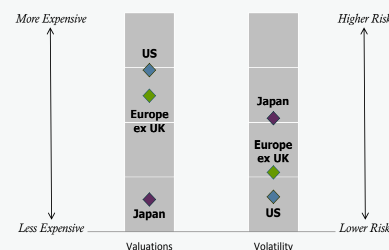
	2000	2001–03	2004–07	2008	2009–13	2014–YTD	
Best Performer	(3.0)%	12.5%	32.7%	(33.8)%	20.1%	14.0%	US Large-Cap
	(9.1)%	6.3%	17.7%	(37.0)%	17.9%	6.7%	Developed World
	(13.2)%	(2.9)%	14.6%	(40.7)%	15.0%	6.2%	Global
	(13.9)%	(3.2)%	13.2%	(42.2)%	14.9%	2.5%	Emerging Markets
	(14.2)%	(3.9)%	9.6%	(43.4)%	14.8%	2.0%	US Small-Cap
Worst Performer	(30.6)%	(4.1)%	9.2%	(53.3)%	12.4%	(1.5)%	Developed International
Difference	27.6%	16.6%	23.5%	19.5%	7.7%	16.8%	

2014 returns through November. Past performance does not guarantee future results. US large-cap stocks represented by the S&P 500; US small-caps by the Russell 2000; developed international by MSCI EAFE; global developed by the MSCI World; global world by the MSCI ACWI, and emerging markets by the reconstructed IFC Index (1981–1984), the World Bank Global (1985–1987) and the MSCI EM thereafter.
Source: IFC, MSCI, Russell Investments, Standard & Poor's, World Bank, and AllianceBernstein

Display 3

Valuations Favor Non-US Stocks, Risk Favors US

Quartile Rankings vs. History

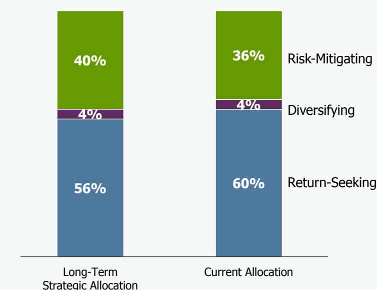


Valuation data as of October 31, 2014, volatility data as of November 21, 2014. Valuation s represented by price to forward earnings, using data going back to January 1987. Index volatility based on availability: S&P 500 since January 1990, EURO STOXX 50 since January 1999, NIKKEI 225 since January 2001
Source: Bloomberg and AllianceBernstein

Display 4

Tilting to Return-Seeking Assets

For a Tax-Aware Moderate Growth Account



As of November 26, 2014
Risk-mitigating assets include 3% allocation to cash; return-seeking assets include equities and high-yield bonds.
Due to an enhancement to our strategic allocation, DAA now includes an allocation to real assets, as well as alternatives, within the diversifying category
Source: AllianceBernstein

Focus on Oil

Secular, cyclical, and political factors combined to drive the price of West Texas Intermediate crude oil down about 35% from $107 per barrel in mid-June to under $70 near the end of November. While the price of oil could fall lower in the next few months, it is likely to be back above $80 by year-end 2015, in our analysis. If not, low investment would create a supply shortage that could drive oil prices well over $100 per barrel in three to five years.

The secular factor weighing on oil for some time has been the relentless rise in US oil production from shale fields. The cyclical factor has been weak global demand, due to slow economic growth in Europe, Japan, and some emerging markets.

The political factor is newer: Saudi Arabia has been trying to impose discipline on the rest of OPEC and the US shale industry (and, perhaps, put pressure on the Russian and Iranian economies) by keeping up production as Libyan supply recovered despite a three-way civil war.

These moves have already resulted in delays to some US shale oil projects and sent a signal to other OPEC members that they have to share in production cuts to offset non-OPEC supply. Nonetheless, OPEC voted at its late November meeting not to cut production.

The Short-Term View

We expect the price of oil to fluctuate for the next few months on speculation around OPEC's next moves, the odds that a deal with Iran on nuclear power will lift sanctions on Iranian oil, and other difficult-to-analyze issues. Options markets currently imply a 15% chance that the price of oil will fall another $10 per barrel by early 2015.

But as 2015 goes on, shale oil cost economics should put a floor under prices and push the price of oil above $80 a barrel by year-end.

While breakeven points for shale oil projects range widely (**Display 5**), about 10% of new wells planned for 2015 would lose money if oil stays under $80. Nearly 25% would lose money if oil stays below $70. Funding for new projects would be costly: The bond market isn't blind to the risk from low oil prices. High-yield bonds for US energy producers now offer the widest yields relative to the generic high-yield bonds in a decade.

Major oil-producing countries in and out of OPEC may also cut production (as the Saudis want). Few of them can sell oil at $80 per barrel or less without running massive budget deficits or slashing spending, which could trigger social unrest.

The Longer-Term View

If oil prices decline further this year and do not rebound in 2015, more projects with high break-even points and long lead times are likely to be deferred, resulting in a dramatic price spike three to five years ahead.

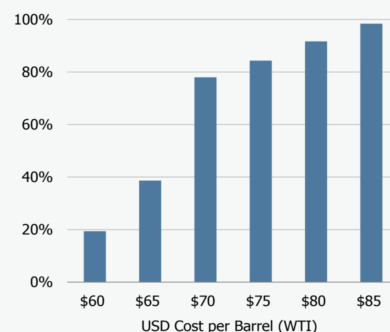
The world needs to develop an additional six million barrels a day of supply every year to compensate for declines in existing wells. If new projects are deferred, we estimate that in three years or so, OPEC would have to draw down spare capacity—perhaps to dangerously low levels.

Under such delicate conditions, even a minor geopolitical shock could propel prices above $150 per barrel. Let's be optimistic and assume that geopolitical conditions are calm in the three to five years: prices would still have to rise well above $100 per barrel to compensate for the risk of a shock and to attract enough investment to make up for years of underinvestment.

Display 5

Oil Below $80 Would Lead to Deferred Projects

Share of Planned Shale Oil Production for 2015 by Break-Even Point



As of late November 2014
Source: WoodMackenzie and AllianceBernstein

Oil has been trading above $90 for most of the last three years. Anything less than that would be good for the global economy and the stock and bond markets but bad for investments in oil (and for countries that rely on oil exports). Oil prices below $80 would amplify those impacts.

Since our research suggests that oil below $80 late in 2015 would lead to oil above $100 by 2018 to 2020, we think it makes sense for long-term investors to have exposure to long-term oil prices, either directly through long-dated energy futures or indirectly through shares of energy companies.

Our Real Asset portfolios include both energy futures and energy stocks. We think that the short-term downside risk is more than offset by their longer-term upside potential and the hedge they provide to clients' overall asset allocation.

The Capital Markets at a Glance

As of November 30, 2014	GDP Estimates 2015 (AllianceBernstein)	Stock Indexes*: November 2014 Return (USD)	Stock Indexes*: Year-to-Date Return (USD)	Stock Indexes*: Price/Earnings Next 12 Months	Stock Indexes*: November 2014 Dividend Yield
Global	3.1%	1.7%	6.2%	14.8x	2.4%
US	3.8%	2.7%	14.0%	16.1x	1.9%
Developed International**	1.6%	1.4%	(1.5)%	14.2x	3.0%
Emerging Markets†	4.2%	(1.1)%	2.5%	10.7x	2.7%

	Current	One Month Prior	One Year Prior
Yields			
US Effective Federal Funds Rate	0.10%	0.07%	0.07%
US Treasury, Three-Month	0.02%	0.01%	0.06%
US Treasury, Five-Year	1.49%	1.62%	1.37%
US Treasury, 10-Year	2.18%	2.35%	2.75%
Municipal Bond 1–10-Yr. Barclays Index	1.42%	1.40%	1.86%
Exchange Rates			
US Dollars per Euro	$1.25	$1.25	$1.36
US Dollars per British Pound	$1.57	$1.60	$1.64
Japanese Yen per US Dollar	¥118.69	¥112.11	¥102.37
Commodity Prices			
WTI Crude Oil ($/bbl)	$66.15	$80.54	$92.72
Gold ($/ozt)	$1,175.20	$1,171.10	$1,250.60
Economic Statistics			
US Unemployment Rate (*October 31, 2014*)	5.8%	5.9%	7.2%
US Inflation—CPI (*October 31, 2014*)	1.7%	1.8%	1.2%

Past performance is not necessarily indicative of future results.
**Stocks are represented by: Global—MSCI ACWI, US—S&P 500, Developed International—MSCI EAFE, Emerging Markets—MSCI EM. S&P 500 returns are with gross dividends reinvested. All other indexes are reported with 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

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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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