

Capital Markets Outlook

# Credit Markets Hold the Key

## Spring 2009



- The 2008 financial crisis led to a deep decline in markets and economies, triggering massive policy responses
- Encouraging signs are emerging, but full economic recovery depends on getting lending and borrowing to accelerate
- Markets may be volatile for a while, but attractive valuations may present historic opportunities for long-term investors

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# Intensifying Challenges and Responses

As the downturn intensified, so did the massive response from governments and central banks. These efforts, along with other trends, give us hope for a rebound—but credit markets hold the key.

## An Extremely Challenging Environment

Financial markets remained rocky, as policy makers battled the most severe global economic slowdown since the Great Depression. Investors pulled back from financial markets, unnerved by the turbulence, and stocks continued their declines, falling to at least 50% below their 2007 peaks.

The world's credit markets slowed to a trickle: consumers and businesses grew reluctant to borrow, banks stopped lending, and there was virtually no activity in markets for securities backed by loans. This undermined confidence, global trade and industrial production...and choked off consumer spending.

Economic growth plummeted in the fourth quarter and continued to decline in early 2009: we expect most major economies to contract this year. Despite the poor outlook, we see many forces beginning to gather for an eventual recovery, although the road won't be an easy one.

## A Massive Global Response

Governments and central banks are slashing interest rates and injecting money into economies and markets in an effort to restart credit markets, securities markets and economic growth. We are also seeing signs for hope in the corporate sector and help for struggling homeowners on several fronts.

Ultimately, these forces should be effective in addressing the current downturn, and there are early signs of success. But restarting frozen credit markets is the key: a revival of lending isn't a precondition for economic recovery, but it's essential for sustained economic growth.

The global economy and financial markets face real challenges, and it's not clear when the recovery will arrive. But market rebounds tend to appear suddenly, and investors who stay committed to their long-term strategies face historically attractive opportunities in both stocks and bonds.

Reviving credit markets is the key to money mobility and a sustained economic recovery.

# Is the Credit Deep Freeze Thawing?

When credit markets stopped functioning, economies and markets around the world came crashing down. It will take time to re-energize them, but the efforts are intensifying.

## The Global Economy Falls Off a Cliff

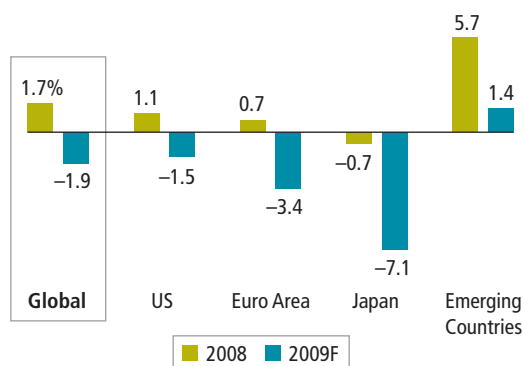
The bear market erased more than \$11 trillion of US household wealth in 2008 and dealt a devastating blow to consumers—who account for 70% of US economic output and half of output in Japan and Europe, as measured by gross domestic product (GDP).<sup>1</sup>

With little activity in credit markets and weaker consumer demand, global trade stagnated. World exports had grown by 26% as recently as May 2008 but began to contract sharply in the second half of the year. In response, companies cut back drastically on production.

With consumers and businesses struggling, world economic growth has plunged into negative territory, and the outlook for 2009 is poor. Based largely on a miserable first half, we expect the global economy to shrink by about 1.9% from last year, with the US, Euro area and Japan contracting—and only emerging markets posting modest positive growth.

**The economic outlook for 2009 is poor, with most regions expected to contract.**

### GDP Forecasts



Historical analysis and current forecasts do not guarantee future results.

As of March 31, 2009

"F" denotes forecasted growth.

Source: AllianceBernstein

## The Source of the Crisis: Frozen Credit Markets

The credit crisis put the brakes on the world, removing vital funding for businesses and consumers.

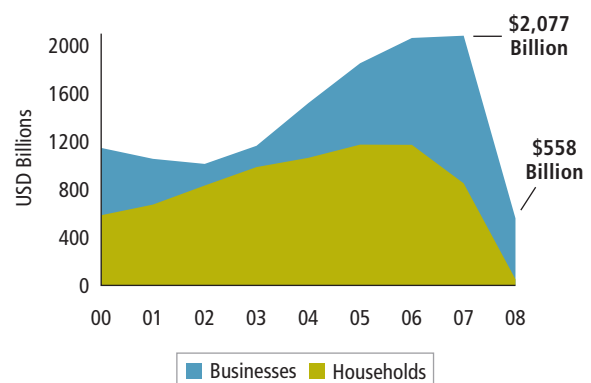
For decades, borrowing had been facilitated by a "shadow banking system," a vast network of investment banks and non-bank financing entities that packaged loans into securities and sold them to yield-hungry investors.

Over time, lending standards were relaxed in the rush to make and sell loans, while low interest rates encouraged many investors and consumers to overextend with leverage. When the subprime problem triggered a vicious spiral, the shadow banking system collapsed.

Businesses couldn't borrow to invest in new projects and consumers found car loans, student loans or home loans out of reach—or available only at much higher rates. The economy needs a recovery in credit markets to sustain an expansion, but this will take some time.

**A shutdown in credit availability intensified the global financial crisis.**

### Borrowing by Sector



Historical analysis does not guarantee future results.

Annual borrowing through 2008

Source: US Federal Reserve and AllianceBernstein

<sup>1</sup> US Federal Reserve and World Bank

## Banks Are Working Hard to Rebuild Lost Capital

The credit crisis opened deep cracks in the financial system, and it's forcing banks to absorb steep losses on both loans and securities.

In the US, for example, capital losses through February 2009 were about \$850 billion.<sup>2</sup> Banks are making much progress in rebuilding this lost capital, but they've had to rely on many sources—some of them unconventional and unprecedented.

Private funding initially helped fill the gap, but when that faltered, the government stepped in with massive infusions of funds and provided guarantees to select financial companies, which encouraged investors to buy their bonds. With more losses to come, banks are being protective of their capital, which has slowed lending activity.

## Looking for Early Signs of Improvement

What signposts should investors look for that will mark the road to recovery?

The tension in credit markets has to ease—and we've seen encouraging signs of progress. Banks' reluctance to lend may be loosening a bit: the rates they charge each other for loans skyrocketed as the crisis unfolded, but began to retreat in late 2008.

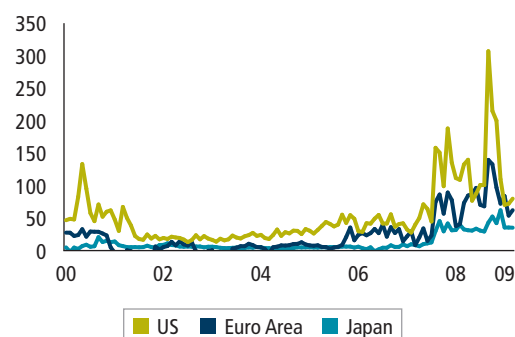
Corporations must also find it easier to issue bonds on their own. Most of the debt they raised in late 2008 included government guarantees, but issuance has continued to grow in 2009, much of it without the government as a facilitator.

Finally, the shadow banking system that aids the flow of credit must come out of hibernation. That's the goal of programs like the US Term Asset-Backed Securities Loan Facility, or TALF, which provides favorable financing for investors to buy asset-backed securities—a critical source of funding for issuers of auto, credit-card and student loans.

## The high interbank lending rates that have choked off credit have started to fall.

### 3-Month LIBOR Spreads

Basis Points



Current valuations and historical analysis do not guarantee future results.

As of March 31, 2009.

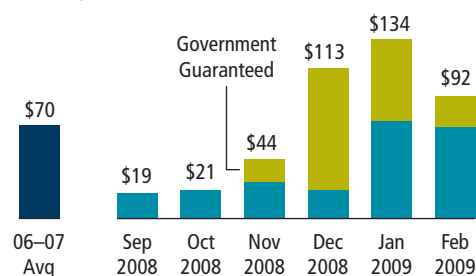
LIBOR is the interbank offered rate and is the world's most widely used short-term lending rate between banks. The LIBOR spread measures the difference between government rates and a bank's lending rate. This difference is a measure of risk in lending between banks. Higher spreads indicate higher rates to compensate for higher perceived risk.

Source: Bloomberg and AllianceBernstein

## Corporations have increasingly found success issuing bonds without government backing.

### Corporate Bond Issuance\*

(USD Billions)



Current valuations and historical analysis do not guarantee future results.

As of February 28, 2009

\*Measures all investment-grade corporate bonds issued globally, in US dollars, regardless of the issuer's home country.

Source: Bloomberg, JP Morgan, Thomson Financial and AllianceBernstein

<sup>2</sup> Bloomberg

# Positive Forces Are Gathering

As help arrives from governments and central banks—as well as from fundamental changes in the economic and corporate landscapes—many stocks and bonds are attractively priced.

## Governments Redouble Their Efforts

The intensity of the downturn has forced governments and central banks to respond massively—and with an unprecedented scope. Since October 2008, they've taken more than 400 separate actions to lift economic growth.<sup>3</sup>

Central banks have slashed interest rates to get money flowing. Some central banks, like the US Federal Reserve and Bank of England, have flooded their economies with cash by buying securities for their own accounts—a technique called “quantitative easing.” Massive fiscal packages aiming to support economic growth have seen some early success—even though much of the funding has yet to be disbursed.

A slew of new programs have committed trillions of dollars to restart credit markets, relieve banks of “toxic” assets and—as TALF hopes to do—break the ice in markets for loan-backed securities. It's hoped that these actions will make more loans available to more consumers at lower rates.

## More Help Arriving from Other Sources

Other developments beyond government efforts have helped boost the chances for an eventual recovery.

Corporations have been paring expenses and slashing production, making them leaner and better poised for an eventual recovery. Housing completions have plummeted: this is hurting economic activity now, but has begun to reduce the surplus of homes that's weighing on real-estate markets, creating a more stable foundation for home values.

Falling home prices have certainly hurt household wealth, but the potent combination of lower home values, cheaper mortgage rates and government incentives has made home ownership less expensive—both for new homeowners and those who can refinance at lower rates. Meanwhile, cheap oil prices have cut homeowners' energy costs by nearly half since August of 2008.<sup>4</sup>

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### Governments have marshalled a stunning amount of aid for markets and economies.

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#### Selected Highlights of Government and Central Bank Responses to the Crisis

United States	Europe	Japan	Emerging Markets
<ul style="list-style-type: none"> <li>■ Nearly \$800 billion fiscal stimulus plan to boost economy.</li> <li>■ \$900 billion under the Term Asset-Backed Securities Loan Facility to revive securitization.</li> <li>■ \$1.8 trillion to buy short-term debt issued by companies.</li> <li>■ Public-private partnerships to buy troubled bank assets.</li> </ul>	<ul style="list-style-type: none"> <li>■ European fiscal spending stimulus proposals total almost 1% of its economic production.</li> <li>■ The European Central Bank cut its short-term rates to the lowest in its 10-year history.</li> <li>■ The Bank of England (BoE) authorized purchases of up to £150 billion in assets.</li> <li>■ The BoE lowered its short-term lending rate to a 300-year low.</li> </ul>	<ul style="list-style-type: none"> <li>■ Stimulus plan totaling 4.8 trillion Yen (\$52.2 billion).</li> <li>■ Dropped the key short-term interest rate to just 0.1% to stimulate the flow of credit.</li> <li>■ Buying securities directly from financial institutions.</li> <li>■ Cash payout of 12,000 Yen (\$133) to each Japanese taxpayer.</li> </ul>	<ul style="list-style-type: none"> <li>■ \$586 billion stimulus package in China.</li> <li>■ Brazil's central bank has injected cash into the economy to encourage activity.</li> </ul>

As of March 31, 2009  
Source: AllianceBernstein

<sup>3</sup> ISI, March 19, 2009

<sup>4</sup> Bureau of Economic Analysis, US Census Bureau and *The Wall Street Journal*

## An Extraordinary Opportunity in Bonds

As help arrives, investors can access sizable opportunities in global corporate bonds. The extra yields—or yield “spreads”—of corporate bonds versus government bonds have soared in the global flight to safety.

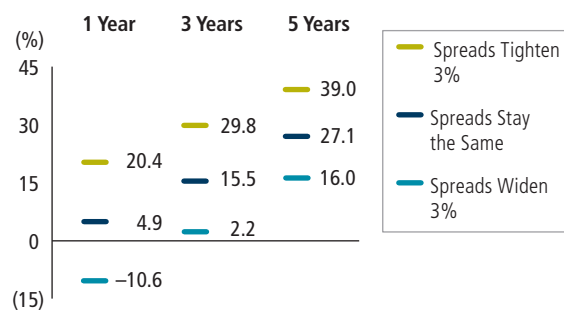
If these yield spreads widen by another 3% over the next year, corporate bonds would likely underperform government bonds by more than 10%; if spreads fell 3%, corporate bonds would likely outperform by just over 20%.

The longer the time horizon grows, the more likely that higher bond yields will work in investors’ favor. Over a three-year horizon, bonds could outperform by nearly 30% if spreads fell by 3%—and outperform by 2.2% even if spreads rose by 3%. The balance grows even more favorable with a five-year horizon.

There’s no telling how long this window of opportunity will remain open, but a long-term approach to investing is the best way to take advantage of it.

### Global corporate bonds are more likely to outperform the longer investors hold them.

#### Excess Returns



Historical analysis does not guarantee future results.

As of March 31, 2009

Expected return calculations are highly simplified and for illustrative purposes only. Assumptions: 5.17-year duration; change in spread (if any) occurs on last day of period. Spreads are 4.91%.

Global investment-grade corporate bonds are represented by the Barclays Capital Global Corporate Bond Index. Individuals cannot invest directly in an index. Please see back cover for index definitions.

Source: Barclays Capital, Moody’s and AllianceBernstein

## Global Stocks: Attractive by Many Measures

Stocks present attractive opportunities for investors, too. In many ways, based on the level of the stock market, the world appears to be on sale.

By the end of 2008, stocks had fallen back to their levels of March 1997, even though the economy produces twice as much output and the corporate sector generates double the earnings per share today. Based on the dividends stocks offer today, equities yield more than Treasury bonds. The opposite was true in 1997.

Of course, stocks still carry plenty of risk. The market could fall further, and investors will have to cope with much higher volatility for a while. But over time, markets tend to return to recognizing fundamentals. Fundamental investors buy companies—not markets—on the basis that over time, growing economies have a favorable effect on corporate earnings and the stock market.

### Earnings and economic production have doubled, but stocks have fallen to 1997 levels.

	1997*	2008*
Global Stock Market Index†	228	228
Global GDP (\$ Trillions)‡	\$35.9	\$69.2
Global Earnings per Share^	\$10.09	\$21.29
Price/Book Value Ratio	2.9×	1.4×
Global Dividend Yield	1.8%	3.9%
US 10-Year Treasury Yield	5.7%	2.2%

Historical analysis does not guarantee future results.

\*1997 is December 31, 1997; 2008 is December 31, 2008

†MSCI All Country World Index, which is a global stock market index that includes emerging markets. Individuals cannot invest directly in an index. Please see back cover for index definitions.

‡Based on calendar years 1997 and 2008 (estimated)

^Trailing 12 months

Source: Bloomberg, FactSet, IMF, MSCI and AllianceBernstein

# Looking Ahead to the Recovery

Chances are that when the market recovers, it will do so with little warning—and without much good news on the economic front. Make sure your portfolio isn't out of balance.

## Markets Don't Wait Around for Economies

With markets in a prolonged slide, looking at account statements has been an exercise in pain and discouragement for almost every investor—even experienced ones.

Reading the newspaper headlines about the economy doesn't offer much hope, either. Growing unemployment, stagnant economic growth or the latest bad news from the financial sector—this recession, like past ones, seems to be very good at producing uninspiring news.

A history lesson does yield one important piece of good news, though. Stock markets tend to be forward-looking, and they usually start to recover even before headlines from the economic front create much hope for better days ahead. An uninviting economic backdrop doesn't necessarily predict an unsuccessful future.

## "Bad-News" Stock Market Rebounds

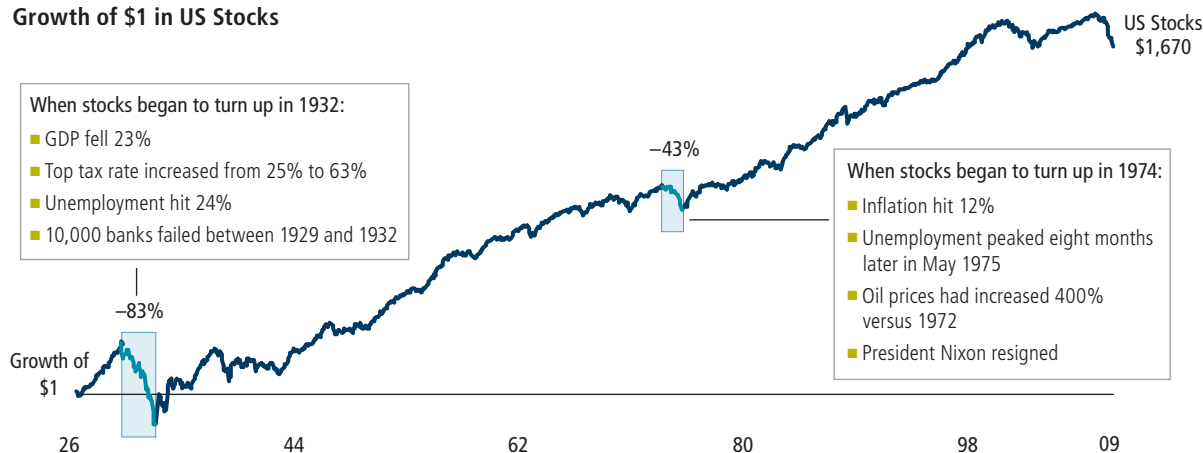
In 1932, the United States was mired in the Great Depression. Economic growth fell 23%, the top tax rate jumped from 25% to 63% and nearly a quarter of the workforce was unemployed. The financial infrastructure was in disarray—10,000 banks had failed over the previous three years.

Still, stocks began to climb that year, and would eventually go on to recover fully and resume their long-term rise. The economic headlines might have said otherwise, but better times were ahead for equity markets.

The US struggled with another deep slowdown in 1974: inflation soared, unemployment continued to climb, oil prices were 400% higher than two years prior, and the President of the United States had resigned. Yet stocks found their footing and began to rally. As these examples suggest, stock market recoveries often start in the darkness before the dawn.

### Stock market recoveries usually start before economic good news shows up.

#### Growth of \$1 in US Stocks



Past performance does not guarantee future results.

As of February 28, 2009

Chart shown using logarithmic scale. US stocks are represented by Ibbotson through 1974 and the S&P 500 thereafter. Individuals cannot invest directly in an index. Please see back cover for index definitions.

Source: Compustat; Roger G. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns," University of Chicago Press *Journal of Business* (January 1976); Standard & Poor's; and AllianceBernstein

## How Long Is the Road Back?

Once stocks resume their upward climb, history says that they'll probably recoup their losses more quickly than you expect them to.

The Great Depression was ushered in by one of history's most severe stock downturns, but a full recovery didn't take decades... it took four and a half years, even after that punishing cycle.

In other US recessions, the turnaround progressed much more quickly. Stocks reached a bottom in October 1974 and then started climbing again. It took them roughly two years to return to their previous peak, but they'd made it 75% of the way in less than half a year. After the Internet bubble deflated, stocks took three and a half years to climb fully back, but produced a 75% recovery in only seven months.

Over the years, even bear markets with very sharp claws tend to give way to surprisingly rapid recoveries—benefiting investors who don't stay on the sidelines.

## Time for a Portfolio Re-balancing Act

In these trying times, you may be tempted to simply leave your most recent statement unopened on the kitchen counter to avoid the pain of looking at what you've lost. However, there's one part of your statement you should be sure to check, and that's your asset allocation.

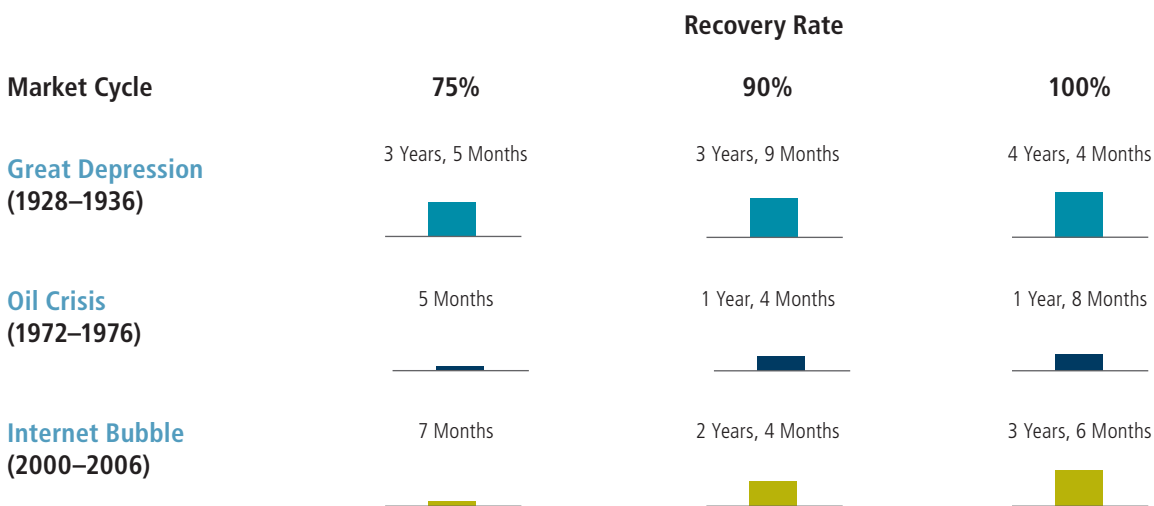
It's very possible that the intense market volatility has altered your portfolio's basic structure in not-so-subtle ways. The fluctuations in the capital markets may have wreaked havoc on your carefully designed balance between asset classes like stocks and bonds. Talk to your financial advisor, review your investment strategy and get your portfolio back into balance.

Your ability to achieve your long-term financial goals may depend on it.

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### Stocks tend to recover a good portion of bear-market losses before long.

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This is a hypothetical example. Past performance is no guarantee of future results. For the Great Depression, the S&P 500 Total Return Index was used with historical dividends applied for periods prior to 1988. The S&P 500 Total Return Index was used for periods after 1988. The S&P 500 stock index is comprised of 500 US stocks and is an indicator of the performance of the overall US stock market. Individuals cannot invest directly in an index. Please see back cover for index definitions.

Source: Ibbotson, Standard & Poor's and AllianceBernstein

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<sup>1</sup> As of March 31, 2009



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**Index Definitions:** The Standard & Poor's 500 Index includes 500 US stocks and is a common measure of the performance of the overall US stock market. The MSCI ACWI (All Country World Index) is a global stock market index that includes emerging markets. The Barclays Capital Global Corporate Bond Index tracks the performance of investment grade corporate bonds publicly issued in the global market.

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