BERNSTEIN

ANATOMY OF RETURNS

After one of the calmest equity markets on record, volatility spiked in early February and has increased periodically since. Fears of higher than expected inflation, angst over potential trade wars, and worry that governments will crack down on social media monopolies: there seem to be concerns coming from many different angles affecting the markets. So in a world where the markets are being hit from all directions, how do investors know what will ultimately drive returns? The answer is simple and rooted in fundamentals: earnings and valuations.

Corporate profit growth is a good predictor of returns over time. In fact, since 2004, returns for the S&P 500 moved alongside reported earnings, in both up and down markets (*Display 1*). This trend can be explained by understanding the drivers of a company's worth.

UNDERSTANDING WORTH

A company's market value typically comes from current earnings and the potential for future growth of those earnings. As earnings rise or are expected to grow, market values generally do, too. However, reported earnings are not the only factor that affects the direction and magnitude of stock price movements; market values are also influenced by what multiple investors are willing to pay for those earnings. Think of multiples as a measure of expensiveness; investors are sometimes willing to pay more, while at other times they demand to pay less. Nonetheless, over the long term, robust reported earnings and expected future growth typically lead to higher market values and stronger returns.

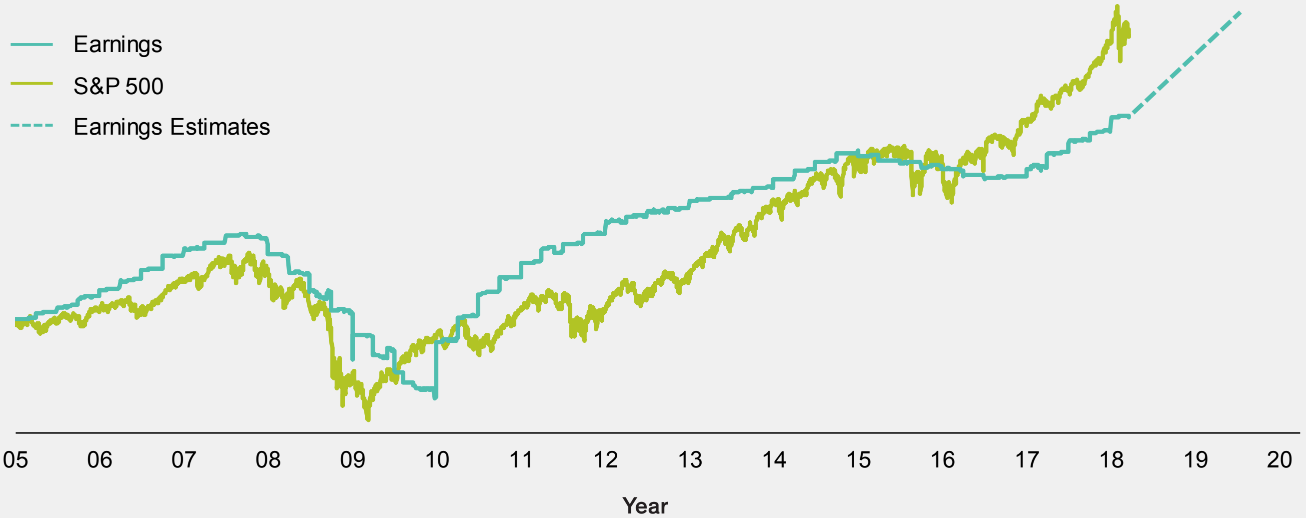
But there can be lags between reported earnings and market returns; they do not perfectly overlap. Sometimes high expectations for future earnings growth can push a company's value ahead of actual earnings while low expectations can be slow to recognize an emerging upward trajectory. This is exactly what happened from 2008 into 2009. As the financial crisis abated, the market began recovering before earnings bottomed out. From the bottom, however, there was a sizable step-up in earnings to catch up to the market growth. Regardless of intermittent separation, the connection between earnings growth and market returns is strong.

Display 1

STOCKS TRACK EARNINGS OVER TIME

S&P 500 Index, Trailing 12 Months Earnings, and Future Estimates

Indexed to December 2004



As of March 20, 2018

Past performance is not necessarily indicative of future results. There is no guarantee that any estimates or forecasts will be realized.

Source: Bloomberg, S&P, and AB

CONTINUED EARNINGS GROWTH?

We also saw this relationship play out in 2017. Earnings grew nearly 11% in the US, 24% in developed-international markets, and 29% in emerging markets, corresponding with market returns of roughly 22%, 25%, and 37%, respectively. Returns continued their upward move in January as robust fourth-quarter results were reported. In fact, 86% of large US companies beat or met industry analysts' earnings estimates, driving market returns precipitously higher.

2018 is shaping up to be another solid year for earnings. Corporate profit growth is forecast to be about 20% in the US, while outside the US, it's anticipated to reach the mid-teens. Part of the growth in the US is coming from the recent tax legislation, which has contributed to consensus growth estimates that have moved up about 8% since the passage of the bill. That said, investors are now also looking beyond 2018 and into 2019. We expect that growth will naturally decelerate in 2019 from 2018 levels but will remain above trend. This deceleration will likely bring down market returns, but we don't expect them to fall off a cliff, as growth will continue to be strong.

RATES UP, MULTIPLES DOWN

Another factor that influences market returns is interest rates. We expect rates to continue to normalize higher from the extremely low levels maintained by the Fed since the financial crisis. We anticipate three more Fed rate hikes in 2018 in addition to the increase announced in March, which should raise the Fed's target range by 1% for the year. Relatedly, we expect rates across the entire yield curve to move higher, and the 10-year Treasury to reach 3.25% in 2018.

Typically when interest rates are low, markets can support higher valuation multiples, and vice versa (*Display 2*). However, the relationship is not linear. At some point, valuations will cease climbing even as rates fall because investors become unwilling to pay higher and higher premiums. This was the case after the financial crisis, when rates fell to historical lows. However, we assume that as rates normalize in the years to come, valuations will fall closer to historical norms. All other things being equal, lower valuations will be a headwind to returns.

PUTTING THE PIECES TOGETHER

Market returns come from three sources—dividend yield, earnings growth, and changes in valuation. The dividend yield of the S&P 500 has been roughly flat—around 2%—since the early 2000s, and we expect dividends to contribute ~2% over the next 10 years (*Display 3*). Therefore, earnings growth and multiple expansion are the important variables and will be the primary drivers of overall performance in any given year.

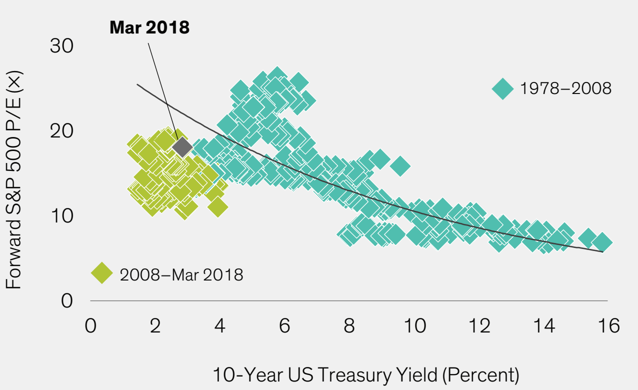
In the years immediately following the financial crisis, earnings growth propelled returns as the economy recovered. Subsequently, multiple expansion pushed markets higher. More recently, we saw earnings growth largely lead the way as all global economies participated in simultaneous, coordinated growth. Over the next 10 years, we believe that earnings growth will provide 5–6%, while valuation will detract from returns.

ROOTED IN FUNDAMENTALS

As with any forecast, especially one that looks many years into the future, market unknowns and surprises can change the outlook. What may seem like smooth sailing can end up being

Display 2

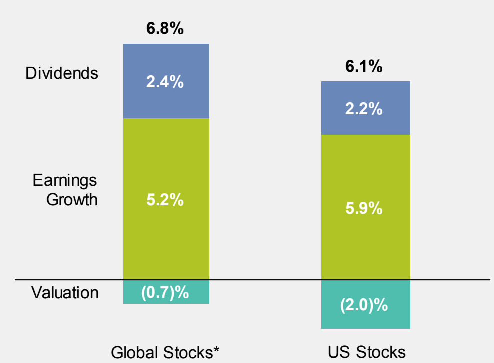
P/E MULTIPLES* AND INTEREST RATES SINCE 1978



As of March 16, 2018
Past performance is not necessarily indicative of future results. There is no guarantee that any estimates or forecasts will be realized.
*Forward P/E multiples represent earnings estimates for the next 12 months.
Chart trend line is for 1978–2007.
Source: Bloomberg, MSCI, S&P, and AB

Display 3

RETURN DECOMPOSITION—NEXT 10 YEARS



Past performance is not necessarily indicative of future results. There is no guarantee that any estimates or forecasts will be realized.
*Global stocks are modeled as 18% US diversified, 18% US value, 18% US growth, 6% US small-/mid-cap, 30% developed international, and 10% emerging markets.
Next 10 years uses the Bernstein proprietary Capital Market Engine forecasts as of December 31, 2017. The forecasted figures utilize book value growth and price-to-book valuations as representations of earnings growth and valuation. **Data do not represent past performance and are not a promise of actual future results or a range of future results.** See Notes on Bernstein Wealth Forecasting System for further details.
Source: AB

the calm before the storm. That's why it is always important to understand the uncertainties that can alter expectations. Today those uncertainties are both geopolitical and economic. Markets are precarious, so staying rooted in fundamentals—in this case, following the earnings and valuations—should pave the way to understanding return expectations.

Market Summary

VOLATILITY CONTINUES IN MARCH

Stocks	**March 2018**	**1Q18**
US	(2.5)%	(0.8)%
Int'l Developed Markets	(2.0)	(1.7)
Emerging Markets	(2.0)	1.3
Bonds		
Municipal	0.1%	(0.6)%
Taxable	0.6	(1.5)
Alternatives		
Hedge Funds	(1.3)%*	1.1%*
Commodities	(0.6)	(2.8)
Real Estate	2.3	(4.6)

Past performance is not necessarily indicative of future results.
There is no guarantee that any estimates or forecasts will be realized.
US stocks are represented by the S&P 500 Index; international developed-market 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 Bloomberg Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.'s (HFRI) Fund of Funds Composite Index; commodities by the MSCI ACWI Commodity Producers Index; global real estate by the FTSE EPRA/NAREIT Developed Index. An investor cannot invest in an index. These figures do not reflect the deduction of management fees and other expenses an investor would incur when investing in a fund or separately managed portfolio. See "Information About MSCI" at the end of this report.

*As of February 28, 2018
Source: Bloomberg Barclays, FTSE, HFRI, Lipper, MSCI, S&P, and AB

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