BERNSTEIN

CHECKING IN ON OUR 2018 SURPRISES

Identifying market surprises is an important element of our investment process. The goal is always to understand not only what the market believes, but also where an outcome could be counter to that belief and how the market may react. At the beginning of this year, we discussed 2018 SURPRISES WE WOULDN'T BE SURPRISED BY. Now that we have half of the year behind us, we lay out the five surprises we identified and where they stand today.

SURPRISE #1: AMAZON UNDERPERFORMS THE RETAILERS

Our surprise prediction for the retail sector is so far, wrong…and right!

This surprise was formulated on the belief that at some point, Amazon's lofty valuation will become a deterrent to investors and as other retailers focus on their distinct competitive advantages, they'll be able to successfully compete against Amazon.

However, again this year, Amazon continues to outperform the retail index. After rising 56% in 2017, AMZN is up 45% through June 29, while the S&P Retailing Index is only up 27%.

But there is a surprise? Amazon is not the best performer, Dillard's and Macy's are performing better thus far (**Display 1**).

Display 1
THE SURPRISE RETAIL WINNERS

Retail sector is defined as the S&P Retailing Index.
Source: Bloomberg

By most accounts, the future of traditional retail is facing major headwinds. That's why it's a bit surprising that some traditional retailers, like 160-year old Macy's, are gaining share and their stocks are the top performers this year. Macy's, for example, has figured out a way to adapt—by streamlining stores and bringing a unique shopping experience through its off-price expansion and a recent acquisition.

Success at traditional retailers shows that while Amazon, and e-commerce in general, is a game changer, it is not limitless. But what's too often lost in the "future of retail" discussion is that many will survive. The survivors will be those whose value proposition includes some combination of unique products, service, shopping experience, convenience, or price leadership. Any retailer who can embody more than one of these consumer values, has the ability to gain market share, while those that cannot will lose and face ongoing headwinds.

SURPRISE #2: QUANT FUNDS CAUSE THE 2018 VOLATILITY SPIKE…NOT GEOPOLITICS

Volatility did return this year, and it was not a function of geopolitics. It was driven by fundamentals and exaggerated by quant funds.

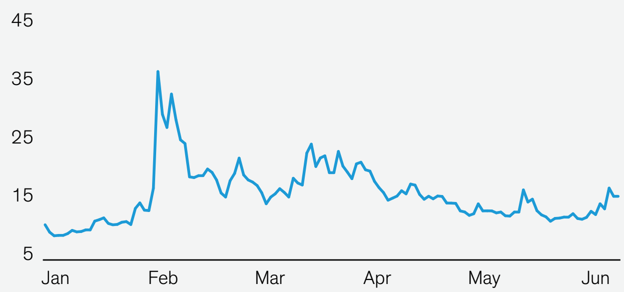
2017 featured some of the calmest equity markets on record—in fact the global equity index was positive in every month in 2017, the first year that has ever happened. So as we entered 2018, we believed that, like other investors, volatility would likely return to the markets. However, our "surprise" was that volatility-targeting quantitative funds, rather than geopolitical tension, could be the cause. And that's basically what happened.

Wage data released by the Labor Department on February 2 showed an uptick in labor costs, triggering fears that inflation was on the horizon. This increase surprised investors, causing the market to fall 10% in two weeks. The Volatility Index (VIX) rose 20 points, or over 116% within the same period (**Display 2, next page**). But did the change in fundamentals justify the magnitude and volatility of the selloff? We don't think so.

Display 2

VOLATILITY SPIKED IN FEBRUARY

VOLATILITY (VIX) INDEX



Year-to-date through June 27, 2018
Source: FactSet

In our opinion, the drastic swings that defined February's equity market sell-off appeared out-of-sync with the economic data on wages, and were more in line with having a "technical" influence. Like several similar events over the last few years, the extremeness of this decline appeared to be the result of a positioning unwind among large quantitative and volatility-focused investors. These investors target a volatility level and automatically sell when levels exceed their target, exacerbating a downward market move. The speed and magnitude of the moves suggests that a "technical" influence was at play, rather than being rooted in inflationary fears.

Events like these are generally transitory, but often induce nervousness and test investment discipline. Unfortunately, there will probably be others. That's why understanding the reasoning behind such large market moves is important. Having clarity behind volatility reduces irrational behavior and an emotional response.

SURPRISE #3: TAX BENEFIT DOES NOT INCREASE CORPORATE PROFITS

While corporate profits did benefit from the tax bill, the full benefit did not fall to earnings as companies increased capital spending to defend market share and grow, and paid one-time employee bonuses.

Following the passage of the 2017 tax bill, many investors assumed the full benefit of the corporate tax cuts would fall to the bottom line for all or most companies. But we postulated that most companies are in competitive industries and would choose to spend much of the savings to defend their positions.

Now six months later, we see that many companies did spend a portion of the savings to strengthen their position, but also to retain talent (one-time bonuses). Shareholders benefited too, as dividends and buybacks increased, as well as earnings.

Earnings continued their upward trajectory during the first quarter, keeping pace with 2017—86% of companies that reported first quarter earnings met or beat forecasts. While earnings grew by an average 22% from a year ago, revenues also increased, by nearly 10%. Moreover, forecasts for the full year are rising, in part because analysts continue to expect an approximate 10% boost to EPS from tax relief.

While profits expanded, in part from the tax cuts, companies also focused on defending their market position and driving growth through capital spending, which swelled in the first quarter. They also rewarded shareholders. Over 7% of S&P companies announced a dividend increase in the first quarter, with those increases averaging about 14%, up almost 3% from a year ago. Share buybacks also rose, by over 15%. And per recent reports, in the first half of this year, over 400 companies paid more than $4 billion in bonuses because of their tax savings.

SURPRISE #4: US REGULATORS CRACK DOWN ON INDUSTRY DOMINANCE

Industry dominance has largely continued in 2018.

European regulators have been pressuring large tech companies for years. At the beginning of the year, we thought it was possible for these companies to face similar issues in the US. This surprise, we believed, would have caught most investors off guard since these companies (and their stocks) had been very successful given limited US regulatory scrutiny and most assumed that this favorable stance would continue.

While the year started out as any other, from a scrutiny standpoint, it took a turn when the news related to Facebook and Cambridge Analytica came to light. The privacy issues surrounding this event underscore concerns among some that these companies have too much power and raise the possibility that regulators may target them more formally. While these things take time to play out, so far that has not been the case.

SURPRISE #5: BITCOIN FINISHES THE YEAR AT $50,000...OR $0

We were not trying to speculate on the price of Bitcoin, nor were we making any recommendations regarding its value with this surprise. Rather this was our way of suggesting that there is great uncertainty around Bitcoin, and cryptocurrenices in general.

After a frenzied second half of 2017 when Bitcoin rose over 700%, some investors declared the cryptocurrency would be the currency of the future. Euphoric investors saw no end in sight. For us, the surprise was less about the vertical ride, but more about the uncertainty around its use as a currency, its value as an asset, and its future.

After finishing 2017 at around $13,400 following a considerable climb that peaked at over $19,000, Bitcoin now sits somewhere around $5,900, down 57% year to date.

As we said in January, the valuation of Bitcoin and other cryptocurrencies do not appear grounded in fundamentals. And that's why there is such a debate around the use of cryptocurrencies as a global currency. Conversely, the technology behind Bitcoin—blockchain—continues to show benefits for many sectors potentially transforming the way transactions occur and data is stored.

To learn more, listen to our podcast, CRYPTOCURRENCIES: WHY THE FUSS?

EXPECT THE UNEXPECTED

As we mentioned in our initial note, these surprises, other than Surprise #3, are not our base case. But we consider the impact that these and many other unanticipated events could have on our forecasts. By expecting the unexpected, we prepare for the unforeseen, so we will not be left flat-footed.

Capital Markets Update

INT'L AND EM EQUITIES LED THE WAY DOWN

Stocks	June 2018	YTD
US	0.6%	2.6%
Int'l Developed Markets	(1.2)	(2.7)
Emerging Markets	(4.2)	(6.7)
Bonds		
Municipal	0.2%	0.1%
Taxable	(0.1)	(1.6)
Alternatives		
Hedge Funds	0.7%*	1.2%*
Commodities	0.1	5.0
Real Estate	1.4	0.4

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 May 31, 2018
Source: Bloomberg Barclays, FTSE, HFRI, Lipper, MSCI, S&P, and AB

© 2018 AllianceBernstein L.P.

Information About MSCI
MSCI makes no express or implied warranties or representations, and shall have no liability whatsoever, with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indexes or any securities or financial products. This report has not been approved, reviewed, or produced by MSCI.

Note to All Readers
The information contained herein reflects, as of the date hereof, the views of AllianceBernstein L.P. (or its applicable affiliate providing this publication) ("AllianceBernstein") and sources believed by AllianceBernstein to be reliable. No representation or warranty is made concerning the accuracy of any data compiled herein. In addition, there can be no guarantee that any projection, forecast, or opinion in these materials will be realized. Past performance is neither indicative of, nor a guarantee of, future results. The views expressed herein may change at any time subsequent to the date of issue hereof. This material is provided for informational purposes only, and under no circumstances may any information contained herein be construed as investment advice. AllianceBernstein does not provide tax, legal, or accounting advice. The information contained herein does not take into account your particular investment objectives, financial situation, or needs, and you should, in considering this material, discuss your individual circumstances with professionals in those areas before making any decisions. Any information contained herein may not be construed as any sales or marketing materials in respect of, or an offer or solicitation for the purchase or sale of, any financial instrument, product, or service sponsored or provided by AllianceBernstein L.P. or any affiliate or agent thereof. References to specific securities, if any, are presented solely in the context of industry analysis and are not to be considered recommendations by AllianceBernstein. AllianceBernstein and its affiliates may have positions in, and may effect transactions in, the markets, industry sectors, and companies described herein.

The [A/B] logo is a registered service mark of AllianceBernstein, and AllianceBernstein® is a registered service mark, used by permission of the owner, AllianceBernstein L.P.

This document is provided for informational purposes only, reflecting prevailing market conditions and our judgments as of the date indicated herein. Opinions and estimates may be changed without notice and involve a number of assumptions that may not prove valid. Neither this document nor any of its contents may be used for any purpose without the consent of AllianceBernstein.

1345 Avenue of the Americas, New York, NY 10105, 1.212.486.5800