FOLLOW THE EARNINGS
Some investors are troubled by historically rich equity valuations in the US. Others fear that the length of the recovery alone indicates that a correction is due. And many are puzzled by the market’s apparent calm, as shown by extremely low volatility despite unnerving geopolitical and social tensions.

But we would argue that the reason for the extended rally isn’t so mysterious: The uptrend in equity markets around the world in recent quarters reflects an upswing in expected earnings growth that should continue in the near term. While earnings per share (EPS) growth and market returns are not necessarily correlated over a full market cycle, today’s modest, but synchronous, mid-cycle acceleration in global economic growth is providing support to both.

Granted, strong stock market gains over the past year may reflect much of the positive news on earnings. And earnings could disappoint loftier expectations. Also, still-modest economic growth could be stymied by policy missteps. The most significant risk, in our view, is monetary policy: Since historically low interest rates have supported the prices of stocks and other assets for years, a change to less accommodative policies must be managed carefully. Central bank rate hikes are widely expected to be gradual, well telegraphed, and appropriate to economic trends, so more rapid or larger-than-expected monetary tightening could disrupt markets.

In addition, while hopes for significant US fiscal stimulus have faded in recent months, uncertainty about the Trump administration’s tax, budget, regulatory, and trade policies—and their likelihood of getting through Congress—adds another layer of risk, as does a host of geopolitical concerns.

Nonetheless, we expect near-term earnings growth to help equity markets withstand potential headwinds. We project global stock returns in the 6% to 7% range over the next five years, lower than they have been historically but better than expected returns from other liquid financial asset classes. Notably, from a valuation perspective, non-US equities look more attractive than US stocks, and client accounts with Dynamic Asset Allocation are now slightly overweight equities in Europe and emerging markets.

To explain our views, this paper will look at the current interplay of earnings, market valuations, and volatility.
FUNDAMENTALS SUPPORT STOCK MARKETS
While economic growth since the Great Financial Crisis of 2008 has been tepid, we expect global economic growth of 2.8% in 2017, up from 2.4% in 2016. That would be the best increase since 2010, with broad regional participation. We expect similar global growth in 2018, but with more of the positive momentum coming from emerging economies.

Inflation remains quite low by historical standards, and while interest rates are expected to rise gradually, monetary policy remains accommodative. This combination of moderate global growth with low but slowly rising interest rates and subdued inflation has been, and should continue to be, good for corporate earnings and stock prices.

Furthermore, while the US has led the earnings recovery since 2009, the recent acceleration in earnings growth is broadly distributed around the globe (Display 1) and across sectors and companies. More than 60% of companies in the MSCI All Country World Index, which includes both developed and emerging markets, reported accelerating earnings this year, up from about 40% a year ago (Display 2, next page).

**DISPLAY 1: EARNINGS GROWTH IS EXPECTED TO REBOUND GLOBALLY**
Indexed Earnings per Share (EPS) Growth by Market

<table>
<thead>
<tr>
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<th>2017E</th>
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<tr>
<td>US</td>
<td>11%</td>
<td>12%</td>
</tr>
<tr>
<td>Japan</td>
<td>14%</td>
<td>8%</td>
</tr>
<tr>
<td>EM</td>
<td>23%</td>
<td>11%</td>
</tr>
<tr>
<td>Europe</td>
<td>22%</td>
<td>9%</td>
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Historical results and current forecasts do not guarantee future results. There is no guarantee that any estimates or forecasts will be realized.

As of May 31, 2017
EPS for each index was indexed to 100 as of July 1, 2009, and grown on the basis of 12-month trailing EPS reports through May 2017; forecasts for 2017 and 2018 were added. US represented by S&P 500; Europe, Japan, and emerging markets (EM) by the MSCI Europe, Japan, and Emerging Markets indexes.

Source: FactSet, MSCI, S&P, and AB
Importantly, there is no one cause for this improved earnings outlook and, thus, no one factor that, if it reversed unexpectedly, is likely to derail the current momentum. Rather, broad-based fundamental strength from improving business and consumer confidence, solid manufacturing indicators (Display 3), and falling unemployment are supporting earnings growth globally.

**US EARNINGS RECOVERY RESUMES AFTER A PAUSE**

Consensus estimates call for S&P 500 earnings per share (EPS) to rise 11% in 2017 and 12% in 2018, compared to a disappointing stretch from 2014 through 2016 (as Display 1 also shows). Importantly, the acceleration in earnings growth has nothing to do with possible policy changes from the Trump administration.

Earnings weakness from mid-2014 to mid-2016 was due to three factors: plummeting oil prices that dragged down energy company earnings, an inventory build that weighed on global manufacturing, and a rising US dollar, which hurt the earnings of large US exporters.

Trends for all three factors have now reversed. The earnings recovery has been bolstered by an oil price recovery/stabilization that began in late 2016; a shift by manufacturers from de-stocking to re-stocking inventories; and US dollar weakening versus most other currencies in 2017. The oil and inventory recoveries have also supported earnings growth in other parts of the world to varying degrees.

And US stock price performance this year reflects diverse trends rather than uniform themes. Consumer-oriented technology companies (such as Facebook, Apple, Amazon, and Alphabet) have led, because investors are drawn to their appeal as dominant companies in rapidly growing markets.

Conversely, some industries, like retail and grocery, have pulled back recently as the threat of Internet disintermediation has become more tangible. Sectors as diverse as utilities, healthcare, and consumer discretionary have done well.
AT LAST, EUROPEAN EARNINGS RECOVER

After six years of stagnation, European earnings are expected to increase more than 22% in 2017 and 9% in 2018. That’s much stronger than expected earnings growth in the US, because the European recovery is at a much earlier stage. Unlike the US, the European economy wasn’t only slammed by the credit crisis in 2008 and 2009: Its nascent recovery from the crisis-induced recession was stifled by the sovereign debt crises of 2010 and 2011, which depressed economic and earnings growth for years thereafter.

But Europe’s economy is gradually strengthening and becoming more balanced across countries. We forecast 1.9% GDP growth in 2017, above the consensus view of 1.6%. We are also seeing a slow uptrend in core inflation from near-deflationary levels. Unemployment has been ticking down, though it remains very high at around 9%. Household spending appears to be solid, and indicators point toward continued growth.

Indeed, pent-up consumer demand in Europe is expected to be a key support for the economy and the earnings of consumer-related companies in 2017. Having recently weathered several intense periods of political uncertainty, from the Brexit vote a year ago to the French elections this spring and the recent UK election surprise, consumer confidence has improved from very low levels (Display 4). While notable elections in Germany and Italy remain, and great uncertainty about the path of Brexit will continue, investors in Europe should begin to breathe more easily.

![Pent-up consumer demand in Europe is expected to be a key support for the economy and the earnings of consumer-related companies in 2017.](image)

Business confidence has risen to the highest level in six years, the composite PMI survey shows, and business spending has been strengthening for several quarters. Operating leverage is also a big part of the recovery story. Many European companies have cut costs substantially, so faster revenue growth should quickly translate into higher profitability. For example, margins at Peugeot, the French car manufacturer, have significantly increased as the workforce has been reduced by over 30% since the start of the financial crisis.

DISPLAY 4: EUROPEAN CONSUMER CONFIDENCE IS RISING FROM VERY LOW LEVELS

Consumer Confidence (Index)

- 0
- (5)
- (10)
- (15)
- (20)
- (25)
- (30)


**Historical results and current forecasts do not guarantee future results. There is no guarantee that any estimates or forecasts will be realized.**

Through May 31, 2017

A reading of zero is considered neutral; confidence is still below that but is improving.

Source: Haver Analytics and AB
while the company has produced the same number of cars. Another example, again from France, is Michelin, the tire manufacturer. The company increased its operating margin from a trough of 9.7% in 2013 to 13.3% in 2016, despite generally stable revenues.

Financial leverage is also providing support to European companies. Due to monetary accommodation by the European Central Bank (ECB), loan growth is rising (Display 5), and financing costs have fallen. Firms are now better able to borrow to fund growth initiatives or refinance existing loans at lower rates (or both), which also has a positive impact on earnings.

**JAPAN IS BECOMING SHAREHOLDER-FRIENDLY**

With its aging population, Japan has struggled for years with slow economic growth and very low inflation. But small improvements are having a positive impact. Unemployment of just 3% has led to a modest rise in workforce participation by women and the elderly. Eventually, this should boost wages and inflation, with positive impacts for consumer spending and corporate profitability, which remain low versus the US and global averages.

EPS at Japanese corporations is expected to grow 14% this year and 8% in 2018. The earnings recovery partly reflects a nationwide campaign to boost corporate profitability, led by the Abe administration. For example, SCREEN, a maker of semiconductor-production equipment, boosted its operating margin from the mid-single digits three years ago to the mid-teens in its most recent fiscal year.

Shareholder activism is also contributing to Japanese companies’ greater focus on profitability and increasing shareholder value. Many firms are now returning cash to shareholders through dividends and share repurchases (Display 6). We expect this trend to continue, because Japanese corporations still have cash-rich balance sheets: A far greater percentage of large corporations operate with net cash positions in Japan than in the US.

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**DISPLAY 5: EUROZONE CREDIT GROWTH IS PICKING UP FROM A SLUGGISH PACE**

Percent Change in Outstanding Debt (Year-on-Year)

Historical results and current forecasts do not guarantee future results. There is no guarantee that any estimates or forecasts will be realized.

Through December 31, 2016. Dates in x-axis show beginning of each year.

Source: Haver Analytics and Statistical Office of the European Communities
EMERGING MARKETS ARE BENEFITING FROM MULTIPLE TRENDS

After five years of flat or negative results, earnings growth for the emerging markets picked up in 2016 and is expected to near 23% in 2017 and 11% in 2018, far faster than in developed markets overall.

While the emerging markets include 23 countries with differing dynamics, broadly speaking, emerging-market economies are back in expansion mode, widening their economic growth advantage versus developed-market economies. Current account deficits have shrunk, making many emerging nations less reliant on foreign capital and less vulnerable to external shocks. Debt levels are falling, and inflation is contained. Faster global growth has also contributed to stronger commodity prices and exports for hard-hit economies such as Argentina and Brazil.

Expected earnings growth is particularly strong in Asia. In Korea, momentum is led by the export-focused tech sector, which dominates the Korean stock market. For example, at Samsung, the largest stock in the sector, an expected 14% increase in sales should result in an impressive 67% in earnings, due to the company’s fixed cost base.

In China, too, many companies have strong operating leverage, leading to 16% expected growth in earnings. While global investors can always be surprised by changes in Chinese policies that affect local credit and property markets, Chinese companies are benefiting from the stronger tone of the global economy.

A big risk to emerging-market (and Japanese) earnings comes from the potential for restrictive US trade policies. But in our view, a full-fledged trade war is unlikely, because unilateral import restrictions on shipments from Mexico or China could disrupt long-established global supply chains and push up costs for US consumers.

DISPLAY 6: JAPANESE FIRMS ARE BECOMING MORE SHAREHOLDER-FRIENDLY
Cash Returned to Shareholders (JPY Billions)

Historical information is for illustrative purposes only. Past performance does not guarantee future results.

As of March 31, 2017
Share buyback and dividend payout at TOPIX component companies
Source: Nomura Securities, Tokyo Stock Exchange, and AB
VALUATIONS IN THE US AND ELSEWHERE

While the earnings picture is positive, it’s fair to ask whether the good news has already been factored into stock prices. The answer varies widely by market.

With the S&P 500 trading at 19 times forward earnings in mid-June, valuations are near the high end of what we’d call their normal historical range, though nowhere near their all-time highs. We do not expect price/earnings (P/E) ratios to rise from here, which puts the burden on earnings to support stock price growth.

But relative to interest rates, market valuations don’t seem unreasonable. You can see this in Display 7, which plots the S&P 500’s P/E ratio versus 10-year Treasury yields since 1978. The curved line in the display shows the strong relationship between the market P/E and interest rates over nearly 30 years before the credit crisis began in 2008. In general, stock market valuations have been high when interest rates were low—and low when interest rates were high. That’s logical, because low interest rates reduce the cost of corporate borrowing as well as the discount rate that investors apply to future corporate earnings.

DISPLAY 7: US STOCK VALUATIONS SEEM REASONABLE, GIVEN LOW INTEREST RATES
Valuations and Interest Rates Since 1978

Through June 19, 2017

Historical results and current forecasts do not guarantee future results. There is no guarantee that any estimates or forecasts will be realized.
Forward P/E reflects earnings estimates for the next 12 months.
Chart trend line is for 1978 through 2007.
Normal range includes valuations between the 10th and 90th percentiles from 1978 through June 19, 2017.
Source: Bloomberg, S&P, and AB
As the display also shows, today’s P/E level would still be in line with historical norms if the yield on the 10-year Treasury note rose to 4% or 5%, a far greater increase than we expect near-term.

What’s even more interesting is the gap between US and non-US market valuations (Display 8). After lagging the US stock market for six of the last seven years, non-US stock markets are now far more attractively valued. While lower relative valuations do not in themselves guarantee stronger relative returns going forward, the combination of lower relative valuations and expectations for an ongoing earnings recovery in non-US markets bodes well for potential stock price appreciation.

Indeed, returns through mid-June for emerging-market and non-US developed-market stocks far exceeded those of US stocks, rising 18% and 15%, respectively, in US dollar terms, versus the S&P 500’s 9% return.

(Continued on page 11)
Are Markets Too Calm?

As discussed in our June 2017 “Capital Markets Outlook” and podcast, the defining feature of equity markets this year has been an extraordinary calm. The CBOE Volatility Index (VIX), which captures the expected volatility priced into S&P 500 options, has rarely been lower (Display 9). Global stock market volatility—both realized and expected—has also been very low, though not to the same degree.

We think this reflects some of the positive trends discussed in this paper. Today, the world economy is in its best shape since 2009 and has proven resilient, despite numerous macroeconomic and geopolitical strains. By contrast, for most of the eight years since the credit crisis ended, investors had seen the market as fragile and had fixated on central bank policies, currency risks, and the specter of a collapse in the Chinese economy, fearing that these big issues would disrupt the recovery. These issues drove sentiment and caused stocks to become highly correlated, rising or falling in unison based on the news of the day.

Over the past year, by contrast, investors have shifted their focus to company fundamentals and other issues that affect individual stocks. The result has been lower correlations between pairs of individual stocks, and therefore less market volatility, despite brief spikes in volatility after recent political scares.

DISPLAY 9: EXPECTED MARKET VOLATILITY IS EXTREMELY LOW

CBOE Volatility Index (Percent)

Through June 15, 2017

The CBOE Volatility Index shows market expectations of 30-day volatility; it is constructed using the volatilities implied by the pricing of a wide range of S&P 500 index options.

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

Source: Chicago Board Options Exchange (CBOE)
How Long Can the Good Times Roll?

There’s no question that this stock market recovery has lasted longer than most. The S&P 500 rally that began in March 2009 is the second longest in postwar history; only the rally that began in 1990 and culminated with the tech stock bubble lasted longer or had delivered a significantly larger cumulative gain (Display 10).

We think the US economy has shifted from recovery to modest expansion mode.

However, the US economic recovery from the very deep 2008 to 2009 recession has also been slower than all but one recovery since the end of World War II, with average annual growth of only 1.8% (Display 11) and average annual employment growth of 1.4%. Nonetheless, extended slow growth has healed most of the damage that the Great Financial Crisis inflicted on the US economy and labor market, in our view.

We think the US economy has shifted from recovery to modest expansion mode, supported by the fact that most major economies are earlier in their recoveries and posting positive and accelerating growth as well. Central banks are being cautious in removing monetary stimulus. We see no sign that the US and global economic expansions are in serious jeopardy.

We are not complacent. While the US equity market has recently been unusually calm (see “Are Markets Too Calm?”), there may be bouts of volatility, perhaps set off by political conflict or by faster-than-expected interest-rate moves in the US or elsewhere. But recent volatility spikes have been short-lived because corporate health has been good. We expect earnings momentum to support the US and global stock markets for the foreseeable future.

In the longer run, the key questions for us as investors will be how companies adapt to several long-standing challenges: aging populations, technological disruption, and stubbornly low productivity. The differentiation between winners and losers will likely be significant, providing abundant opportunity for active managers to provide incremental return over the modest index returns we expect.

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