To Our Clients:

After a relatively sleepy summer where stocks mostly traded in a tight range, volatility returned in September as investors refocused on the US presidential election and what’s next for global monetary policy. While much of the debate is focused on outcomes (who) and milestones (what and when), we’re focused on what will happen following change.

On balance, we see the odds favoring the continuation of the current economic cycle, with growth possibly accelerating. This isn’t to say the path from here to there will be easy. In the markets, at least, it never is. But despite considerable uncertainty, two things seem clear: Markets will eventually follow the path of the economy, and now is a particularly bad time to follow the crowd.

THE TALE OF TWO ECONOMIES

Economic downturns are typically met with some combination of monetary and fiscal policy responses. That is, central banks cut interest rates in an effort to rejuvenate spending, and governments lead the way with special budgets for public projects, investment incentives, and other direct stimulus. The recession following the global financial crisis was no different in practice, but it’s not obvious when looking at the data.

Real US GDP has grown by 2.2% through the heart of the current economic cycle. This is slow by historical standards. However, decomposing the headline figure into the private sector (mainly companies and consumers) and the public sector (including federal and local government spending) shows a dramatically divergent picture and provides some important insight into what’s possible ahead (Display 1).

Given the tone around the presidential election, it’s hard to imagine that the candidates agree on anything. However, one thing they have in common is a plan to increase infrastructure spending. Of course, trade and taxes are among other important platform issues. And campaign positions inevitably change once the realities of office and the mood on Capitol Hill figure in. But the idea of increasing fiscal spending to upgrade the physical foundation of the country is one thing about the election that doesn’t seem controversial.

And while the candidates wrangle over the state of the economy, pressure seems to be building on the Fed to begin to tighten monetary policy. At the heart of the debate is the conundrum of modest current inflation versus the potential for asset bubbles. We see more risk in the latter and discuss this further in the next section. The bottom line is that despite the length of the current economic cycle, we believe the economy is on solid footing—before any upside from fiscal spending—and can power through gradually higher rates to extend the cycle from here.

A significant risk to our relatively sanguine outlook, however, is another leg up in the value of the US dollar versus other world currencies. If the Fed were to raise rates quickly while the rest of the world stands pat, this could play out. But we think the Fed isn’t the only central bank beginning to question whether current policy has reached a point of diminishing returns. Nor is the US alone in hearing populist calls for more fiscal support. We are watching both closely.

SAFETY BUBBLE (REDUX)

One clear consequence of extreme and extended monetary policy has been the flow of money into asset classes with stability and income characteristics. Over the last few years these have included utility and consumer staples stocks, high-yield bonds, and oil and gas MLPs (master limited partnerships). While we use the term “bubble” to describe elevated valuations, not every bubble bursts in dramatic fashion. Some gradually unwind. And sometimes

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Display 1
Recent Economic Growth Has Been Restrained by Declines in the Public Sector

<table>
<thead>
<tr>
<th>Year Range</th>
<th>Real GDP</th>
<th>Private</th>
<th>Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960 to 2007</td>
<td>3.4%</td>
<td>2.2%</td>
<td>3.8%</td>
</tr>
<tr>
<td>2010 to 2015</td>
<td>3.0%</td>
<td>2.3%</td>
<td>(1.3)%</td>
</tr>
</tbody>
</table>

Source: BEA

Historical analysis does not guarantee future results.
risks are less obvious. For example, we have seen countless instances where the desperate search for yield has meaningfully (but stealthily) changed the overall risk/return characteristics of unsuspecting portfolios.

Today, outside of the bond market where the challenges low rates present are well recognized, we believe risks are most pronounced in pockets of the equity market where monetary policy has disproportionately benefited low-beta (less volatile) stocks. This makes directional sense, because changes in interest rates, which investors use to discount future cash flow, have a big impact on the valuation of low-beta companies, while the valuations of high-beta (more volatile) companies are driven more by the greater risk premiums they carry than by the effect of interest rate changes alone. But this cuts both ways, and markets have a long history of overshooting even if they are generally pointed in the right direction. We think this is the case today as other stock factors (attributes) are at attractive levels across the board, while safety is not (Display 2).

It's easy to be discouraged by politics and global events. And it's only natural to want to know how they will affect your financial future. The reality is that investing has never been simple. No one knows exactly what the future has in store, but Bernstein clients have the benefit of one of the world's largest research teams on their side to help navigate change that, as the saying goes, is the only constant.

Thank you for your ongoing trust in us.

David Barnard

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