BERNSTEIN

2018 SURPRISES WE WOULDN'T BE SURPRISED BY

2017 marked a healthy year for equity markets while fixed income showed resiliency in the face of Fed tightening. This year, Wall Street forecasts a similar environment, with more modest market returns. In general, we agree with this sanguine forecast. But we are also conscious that unexpected events often surprise the markets. This note lays out the five surprises we wouldn't be surprised to see in 2018.

Listen to the podcast here.

THE REALM OF POSSIBILITY

As investors, we like to understand market sentiment and where there is overwhelming agreement on a security or asset class. In other words, what is the consensus belief? We want to know if and how we differ from the collective belief or if our opinion is in line. By understanding consensus thinking, we can analyze the importance of surprises, and how the market may react if results diverge from what's expected. The five surprises we discuss below are not in consensus thinking, nor are they necessarily our base case assumptions. But if they do occur, will the market be surprised and how will investors react?

SURPRISE #1: AMAZON UNDERPERFORMS THE RETAILERS

Amazon is one of the darlings of Wall Street. The stock rose 56% in 2017 and over the last five years has averaged a 44% annual return. Its meteoric rise occurred on the back of, among other things, a category-transforming approach to retail. In 2017, most retailers felt the pain of Amazon's dominance, and investors watched as the rest of the retail sector barely squeaked out positive performance. The consensus is that this pattern continues in 2018 and rewards Amazon with another year outperforming retail peers. But could the market be surprised?

Amazon is one of the most widely held stocks by both institutional and retail investors. In fact, institutional ownership exceeds 60%, leaving very little capacity to grow in new or current portfolios. ETFs alone hold shares worth more than $40 billion. This strong demand has pushed Amazon's valuation to lofty levels, meaningfully higher than the sector. At some point, this relative valuation premium should matter to investors.

In addition, certain retailers are finding success with their distinct competitive advantage. Electronic retailers have found a way to compete by selling high-end products at retail outlets only. They are not offering convenience or price; rather they are finding their niche in quality and delivering an experiential brand interaction that consumers are enjoying. Similar tactics are rewarding luxury retailers, where strong brand loyalty is capturing customers, allowing companies to control supply. On the other hand, some value-based retailers, who can source goods as cheaply as Amazon, are winning by competing on price.

The success certain retailers are having should at some point be more widely recognized. Coupled with the already high level of ownership and lofty valuation, we wouldn't be surprised to see Amazon underperform these other retailers next year.

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

The markets were eerily calm last year. Even in the face of intensifying tensions on the Korean peninsula, elections across Europe, and political turmoil in our nation's capital, the markets barely blinked. But most investors think 2017 was the exception rather than the rule and that 2018 will reintroduce geopolitically-induced volatility. But what else could heighten market volatility?

Volatility-targeting, quantitative funds have risen in popularity over the last several years, amassing several hundred billion dollars of assets. They use strictly quantitative models that assess favorable risk/return opportunities and make investment decisions with little to no fundamental input.

In 2017, the low-volatility, rising equity markets led most of these funds, en masse, to be 5%–10% overweight global equities. This consistent positioning is worrisome because if volatility increases, even a modest amount, these funds would likely reposition and reduce this equity exposure. Unfortunately, the quantitative models directing these funds without fundamental oversight means they would all reposition at the same time and in the same direction, causing an exaggerated market move—a volatility spike.

Volatility spikes are not new. In August 2015, foreign markets fell in the overnight hours on fears of a China slowdown, triggering quant funds to reduce positions. When the US market opened, a huge gap down in prices occurred, causing a panic sell-off by other market participants.

Today, these funds are bigger and there's more of them. If this herd of quant funds shifts in one direction, it can trigger a stampede as other investors join the movement, exacerbating a downward move. This scenario is even more likely given the lack of market corrections in 2017. The last time the market corrected even 5% was over 78 weeks ago, and the anticipation that it's time for a correction could exaggerate even the slightest downward pressure. So, while we agree rising geopolitical risks could be a cause of increased market volatility, we also wouldn't be surprised to see volatility spike due to these model-driven funds.

SURPRISE #3: TAX BENEFIT DOES NOT INCREASE CORPORATE PROFITS

The long-fought battle over tax cuts is now over, and the belief is that the new lower corporate rate will result in more earnings for most companies. The consensus estimates that if corporate tax cuts fall to the bottom lines, there could be approximately 5%–10% of incremental growth to EPS. But what if that belief is inaccurate, and companies spend the savings first?

Most companies are in competitive industries, fighting to defend their market position, while others are trying to grow their share of the market. These tax cuts present the opportunity to do just that. Some companies will likely choose to spend those savings, by boosting advertising or allocating more to R&D, rather than allow them to fall to the bottom line. Others may increase promotions or reduce prices.

Depending on how effectively a company spends these tax savings, they may end up with more or less market share. In some cases, the effect will be short-lived as competitors do the same. The result may be EPS staying at the same level for the vast majority of companies, even with the lower tax rate (Display 1). Stocks that rose on the expectation of higher earnings may be laggards as the year progresses.

SURPRISE #4: US REGULATORS CRACK DOWN ON INDUSTRY DOMINANCE

Dominant control over certain industries has been increasing with minimal interference. These companies have a sustainable growth engine that has been unaffected by the level of economic activity, face little competition, and have pricing power. The consensus is that these companies will persistently perform well and their stock prices will go up on the belief that they can prosper unabated through any environment. But what happens if regulators put the brakes on these controlling companies?

For years, the EU has been attempting to loosen monopolies' reigns of control. Companies that have pricing power and control over consumer information, notably Google, have been targets of fines and antitrust legislation. Although we have seen little evidence of the US doing the same, the precedent set by Europe means the US could follow suit.

Investors, however, are not anticipating any government actions aimed at curbing dominant industry players' control and investors would be caught off guard by an antitrust suit, increased regulation, or fine which could have a significant impact on the future operating model and valuation of these companies.

Display 1

CORPORATE DECISION-MAKING: AN EXAMPLE

Widget Corp ($mm)	2017 (at 35%)	2018 (at 21%)
Revenue	$4,000	$4,000
Cost of Goods Sold	$2,000	$2,000
Gross Profit	**$2,000**	**$2,000**
Operating Expenses	$1,000	$1,177
Operating Profit	**$1,000**	**$823**
Tax Rate	35%	21%
Net Profit	**$650**	**$650**

For illustrative purposes only.
Source: AB

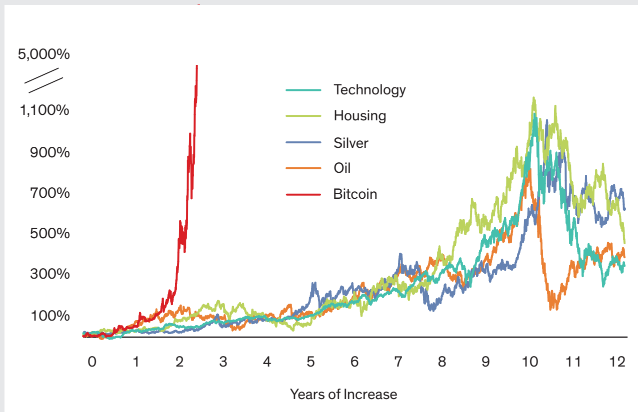
SURPRISE #5: BITCOIN FINISHES THE YEAR AT $50,000...OR $0

The frenzy over Bitcoin has reached a fevered pitch. It's been the rage among some investors during the last half of 2017; each one buying it for their own reason—whether anticipating the currency of the future, or as an indirect way to invest in blockchain technology, or simply because it keeps going up! Investors in Bitcoin and other cryptocurrencies are euphoric as they watch them rise to greater and greater heights (Display 2).

Display 2

BITCOIN REACHED 1,000% RETURN MUCH EARLIER

Bitcoin vs. Other 1,000% Increases



As of December 22, 2017

*Start dates and indexes for each asset are as follows: Tech (NASDAQ Composite Index): March 1990; Housing (S&P 500 Homebuilders Index): July 1995; Oil (WTI Crude Oil): July 1998; Silver (Spot Price per Troy Ounce): May 2001; Bitcoin: January 2015.

An investor cannot invest in an index. These index 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.

Source: Bloomberg, AB

And they see no end in sight. The consensus is…well unlike the other four surprises, there is no consensus thinking on Bitcoin.

Our point of view is that the valuations of Bitcoin and other cryptocurrencies do not appear to be grounded in investment fundamentals. The dramatic swings in price limit their use as a currency and their recent volatility profile is more consistent with that of speculative assets. However, we agree that the technology behind Bitcoin—blockchain—can transform many activities over the long term. But the value of this technology is not what's driving the market price of Bitcoin.

That's why we believe where Bitcoin's price lands by the end of 2018 is anyone's guess. This surprise is a way of showing our uncertainty for where the price could go. We believe the price has an equal chance of skyrocketing as it does of falling drastically.

ALWAYS BEING PREPARED

These are only five of many potential surprises we consider when conducting our fundamental research. We are by no means implying that these events are likely, and other than Surprise #3, they are certainly not our base case forecast. But we constantly think about these and other surprises in our "what-if" scenarios, knowing that the market tends to throw curve balls. Keeping potential unexpected events in mind helps ensure we are not left staring like a deer in headlights.

MARKET UPDATE

Equities were up modestly in December, bringing year-to-date returns to 24% for global markets. Passage of the tax bill dominated headlines, while the Fed raised rates, as expected. Key confidence and sentiment economic indicators fell in December after peaking in November, while housing prices and consumer spending rose.

US and international developed equity indexes gained less than 2.0% in the month, while emerging markets rose 3.6%. Similarly, US fixed income benchmarks were slightly positive in the month as the market digested the tax bill. Despite the Fed rate hike in the month, the 10-year Treasury yield was basically flat.

Global real estate markets were up 1.3% in the month, while the commodity markets were up over 5%. The US dollar was down almost 1% in December bringing year-to-date losses to nearly 10%.

Display 3

TWELVE CONSECUTIVE MONTHS OF POSITIVE EQUITY RETURNS

Stocks	**Dec 2017**	**YTD**
US	1.1%	21.8%
Int'l Developed Markets	1.6	25.0
Emerging Markets	3.6	37.3
Bonds		
Municipal	0.5%	3.0%
Taxable	0.5	3.5
Alternatives		
Hedge Funds	N/A*	6.9%†
Commodities	5.5	13.7
Real Estate	1.3	10.4

Past performance is not necessarily indicative of future results.
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.

*The data are not yet available.
†Through November
Source: Bloomberg Barclays, HFRI, Lipper, MSCI, S&P, FTSE, and AB

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