

Capital Markets Outlook

# The Global Credit Crisis Changes Gears

## Fall 2008



- One year into the credit crisis, there's still plenty of pain...and shocking new headlines
- The turmoil will worsen a global economic slowdown, but the seeds of recovery have been planted
- With capital markets as volatile as they've been in a long time, it's a good idea to make sure your long-term strategy is still on track

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# Dark Clouds Now... But We See Recovery on the Horizon

A fresh round of capital-market unrest has brought new pain—and new anxieties. It may not seem like it right now, but the seeds of recovery have been planted.

## New Headlines...and a Crisis of Confidence

Financial markets have been under siege lately, as the year-old credit crisis takes a new turn. Investors have to cope with a fresh round of shocking headlines and a crisis of confidence among large financial institutions.

The result: several high-profile financial institutions were taken over by governments, went bankrupt or were forced to sell themselves to find the capital they needed to stay in business. Transmitted through a global financial web, the crisis began to take hold around the world.

Credit markets effectively stopped functioning, and the ability to fill a basic need such as borrowing money became a looming question mark. It's a sobering reminder of the deep connections between the financial sector and the economy around us.

In response, central banks are injecting liquidity into markets globally, coordinating rate cuts and considering other forms of intervention. The U.S., for example, is rolling out a historic \$700 billion relief plan and others are following suit.

## Is It Time to Run for Shelter?

Right now, the air's thick with anxiety, investors everywhere are turning their backs on risk, and the headwinds are imposing. With the global economy slowing considerably, things are likely to get worse before they get better.

But they will get better.

The financial sector has already recognized substantial losses: our research strongly suggests that there are more losses to come, but they represent some of the first seeds of recovery. Government help should add stability to capital markets, and in the meantime, the distaste for risk has left markets filled with opportunities.

We'll discuss these topics in more detail in the next few pages, but the bottom line for investors is to stay resilient. Difficult times create opportunities that pave the way for better days ahead. While this is a painful process, it's vital to keep your portfolio on track—and your long-term goals in sight.

There are still more financial-sector losses to come, but the industry has already taken painful and necessary steps toward recovery.

# The Credit Crunch Anniversary

One year into the crisis, venerable financial institutions have crumbled under the weight of unprecedented challenges. It may be hard to see light at the end of the tunnel...but it's there.

## A Historic Financial Crisis

When the U.S. government announced a \$700 billion aid package to shore up capital markets, it marked only the latest chapter in a credit crisis that's saddled the U.S. financial system for more than a year—and is spreading around the world.

So far, the crisis has spawned over \$500 billion of credit-related losses in excess of what we'd expect in a typical credit cycle. The total could eventually top \$800 billion—representing about 3% of total economic production in the U.S. and Europe.

By those dimensions, and with the failures of storied financial institutions and massive government rescue efforts, the latest financial crisis is by definition historic. The losses could end up being on par with—or greater than—the hit the U.S. economy took in the early 1990s' savings-and-loan bust.

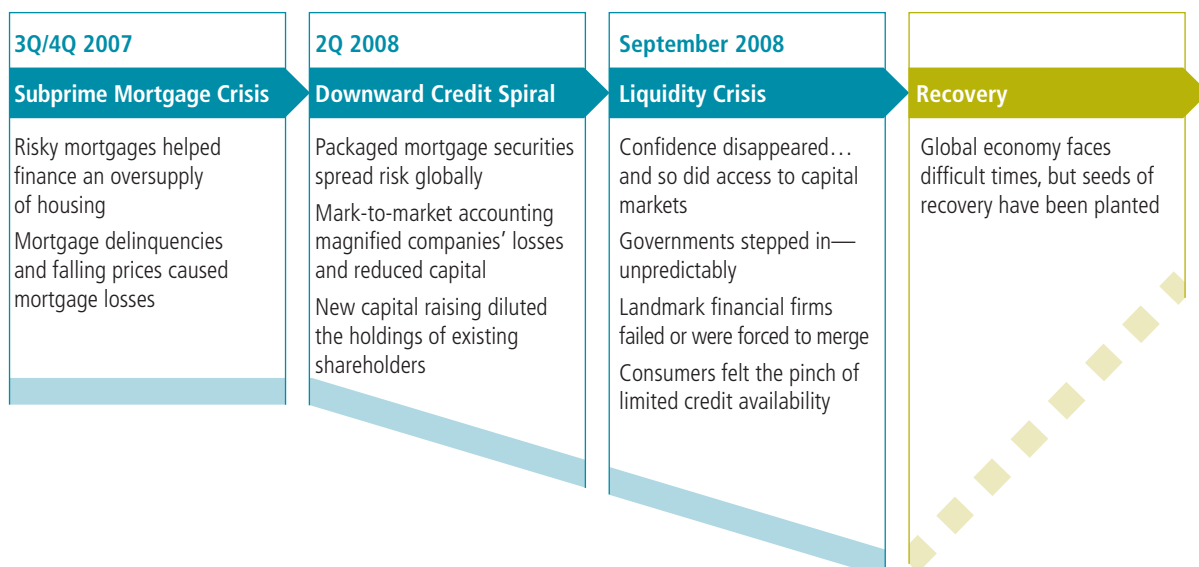
## The Latest Complication: New Capital Choked Off

What's triggered the latest phase of the credit cycle?

Essentially, financial companies have seen their access to new capital shut off. The ability to raise capital is the lifeblood of the financial industry—it's enabled many prominent financial institutions to replace capital they've lost during this downturn.

For the time being, that source of strength has been lost. The inability to raise funds to support businesses is the immediate cause of the troubles with Belgian financial giant Fortis, Fannie Mae and Freddie Mac, Lehman Brothers, AIG and other industry titans. As we'll explain, this credit freeze is being felt far beyond the financial world.

### The Credit Market Crisis Escalated



## Eye-Opening Headlines Aren't New

Today's headlines may seem shocking and provocative, but they're certainly not unique.

Well-known financial institutions have failed before during market meltdowns. In the last negative credit cycle, which happened in 1990, Drexel Burnham Lambert failed. At the time, it was the fifth largest investment bank, and it wasn't alone. Many big banks in Texas and New England, and some 2,000 U.S. savings-and-loans, also failed.

Losses from this most recent crisis certainly aren't over, but techniques like mark-to-market accounting for bad mortgage-related investments are causing financial institutions to recognize losses more quickly. This will help resolve this crisis faster than previous ones, such as the Japanese real estate blowup in 1990—it took banks and regulators years to address the damage from that stumble.

## Looking Forward

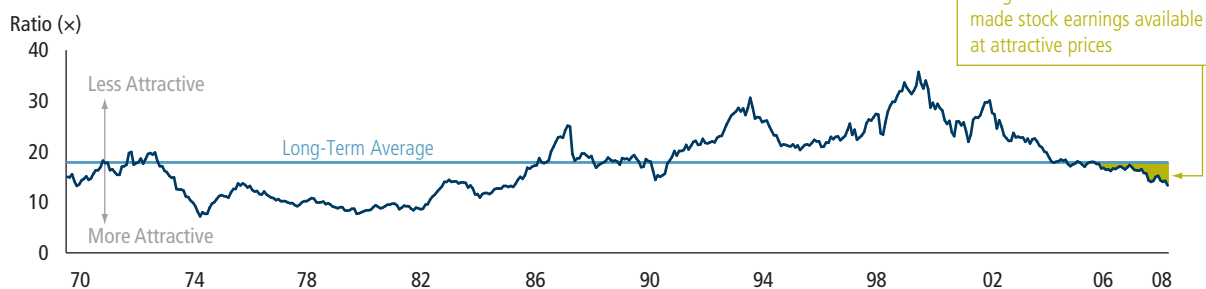
A devastating year has made it easy to forget that the financial-services industry is a highly profitable, multi-faceted, global sector that helps the world turn.

Fundamentals have been discarded for the moment, so it's hard to predict logically where the turmoil will strike next. However, our research suggests that most leading financial institutions have enough capital to absorb the losses to come, and that the crisis will eventually pass.

When the economy recovers, stronger firms everywhere will benefit. And right now, indiscriminate selling has left stocks at attractive valuations—as highlighted by their price/earnings ratio. This ratio estimates how much investors must pay to buy one dollar of stock earnings. At the end of the third quarter, it revealed stocks to be as cheap as they'd been in nearly two decades.

### Lower P/E Ratios Mean Stocks Have Grown More Attractive Globally

#### Price/Earnings Ratio\* of MSCI World Index



Historical analysis does not guarantee future results.

As of September 30, 2008

Individuals cannot invest directly in an index. See back cover for index definitions.

\*12-month trailing earnings

Source: Bloomberg, FactSet, MSCI and AllianceBernstein

# A Deepening Economic Slowdown

The credit crisis seems to be pushing the global economy deeper into a hole, but the seeds of an eventual recovery are already being planted.

## The Big Question

Just what does a bailout of Wall Street have to do with Main Street? The connections may be hard to see, but when financial institutions stop lending, it can hobble entire economies.

With bad mortgage investments weighing on the financial community, lenders stop lending to one another. Small businesses struggle to borrow money to invest in new projects and grow; even large corporations face challenges borrowing short-term funds to meet their expenses. If these expenses include payrolls, layoffs may follow.

Things don't go much better for consumers. Car loans, student loans and home loans dry up. Potential borrowers who do manage to satisfy stricter borrowing standards will probably pay a much higher rate than normal.

When these forces converge, it's easy to see how the current crisis can end up being as much of a problem for everyday consumers as it is for big business.

## An End to Booming Economic Growth

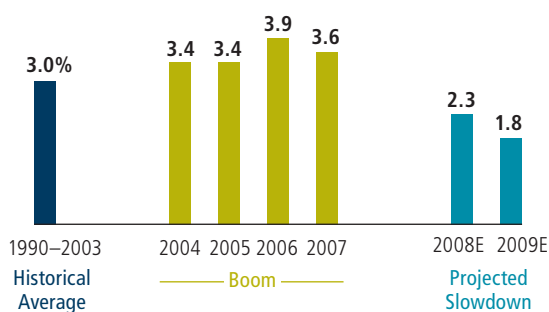
Faltering consumers—vital contributors to every economy—are a big reason that we expect a substantial slow down in economic activity. It's clear now that the U.S. economic downturn has gone on a world tour.

What are the implications for the global economy? The boom years will soon look like a distant memory—with the financial turmoil posing significant downside risks. We expect a pronounced slowdown in global growth rates: from 3.6% in 2007 to 2.3% in 2008 and below 2% in 2009. In the U.S., both the third and fourth quarters of this year will likely check in with negative growth.

Obviously, this will be a challenging time for many of the world's economies, although it will remove a stubborn problem—overheated inflation.

### A Global Economic Slowdown Is Under Way

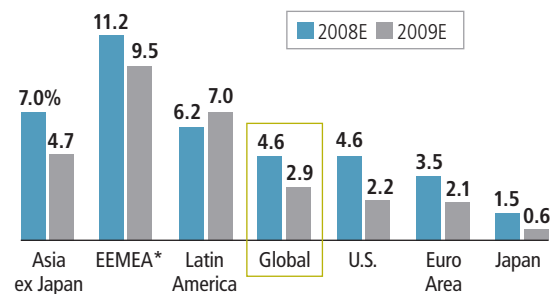
#### Inflation-Adjusted Global Economic Growth



Historical analysis and current estimates do not guarantee future results. Represents compound inflation-adjusted, or real, global economic growth as of September 30, 2008; "E" denotes estimated growth. Source: IMF and AllianceBernstein estimates

### Slower Growth Will Cause Inflation to Ease

#### Projected Inflation Growth



Current forecasts do not guarantee future results.

\*Eastern Europe, Middle East and Africa

Consumer Price Index growth estimates as of September 30, 2008;

"E" denotes estimated inflation.

Source: AllianceBernstein estimates

### Cold Water for Overheated Commodities

After several years of impressive growth, the demand for resources like oil, steel, grains and other commodities has been outrunning the world's ability to supply them. Commodities prices have surged, fueling a sharp upturn in headline inflation.

With the world economy headed for a slump, inflation should recede in every major region except Latin America. For example, we expect U.S. inflation to plummet from 4.6% in 2008 to 2.2% in 2009. In Europe, we estimate inflation should fall from 3.5% to 2.1%, and globally from 4.6% to 2.9%.

For the most part, this will remove inflation as a threat, and give many central banks more flexibility to shift their focus to addressing the economic slowdown. However, central banks must achieve results while working through sluggish credit markets.

### The Seeds of Recovery

Inflation is one relative bright spot, but there are others. Among them: financial institutions have made progress in recognizing subprime losses, falling home prices and supply have whittled away at the housing surplus, and governments are taking action.

The weaker dollar is also teaming up with changing growth patterns to bring more balance to world trade, and one notable example has been somewhat lost in the shuffle. The U.S., which has historically faced a sizable trading deficit, has seen its export growth overtake China's recently.

Since 2007, China's blistering export growth has been slowing and U.S. exports have been growing faster. Since mid-2008, U.S. export growth has actually been higher than China's. This hasn't reduced the large U.S. current account deficit much yet, but if this growth continues, it's likely to have an impact.

Together, we view these and other trends as the seeds of an eventual economic recovery.

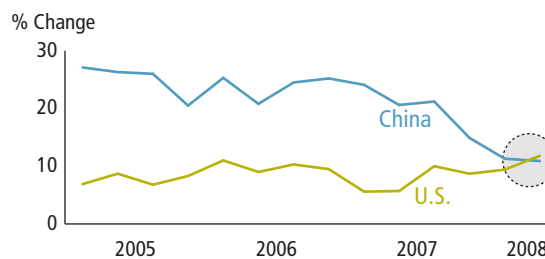
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### U.S. Export Growth Now Exceeds China's

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#### Growth in Exports

Year-over-Year



Historical analysis does not guarantee future results.

As of June 30, 2008

Source: CEIC Data and AllianceBernstein estimates

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# Don't Let Shaky Markets Rattle Your Portfolio

Nervous markets create opportunities, but you'll have to battle your emotions to keep your portfolio on course and stay committed to your long-term strategy.

## Much Anxiety...But Opportunities, Too

It may take some time for the seeds of recovery to grow, but they will grow, and financial markets will eventually recover. But for now, they seem to be in a constant state of upheaval. Frustrated investors feel like every time they see a light at the end of the tunnel, a new controversy shows up to turn off the lamp.

With anxiety swirling, many investors have abandoned any asset thought to be risky. As a result, investments in every corner of the capital markets offer substantial extra return potential.

This "risk premium" has soared along with fear, and history shows that investments made in these moments of distress, when potential is much higher than normal, are usually the most rewarding.

## Emotion Versus Strategy: Who's Winning?

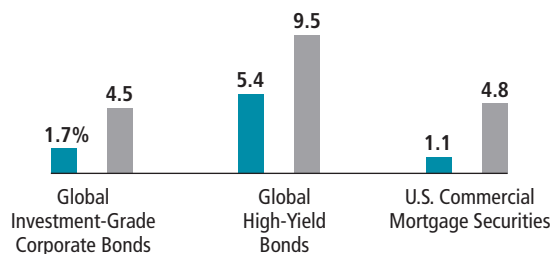
But to reap those rewards, you'll have to follow the time-tested approach of staying invested for the long term—even though it's usually accompanied by a time-tested case of anxiety.

The flow of individual investors' money shows that in the battle between emotions and sound strategy, emotion has taken the upper hand. In this case, the fallout from the credit crunch has deteriorated into a full-fledged flight to quality, with many investors abandoning long-term strategies for the perceived safety of cash.

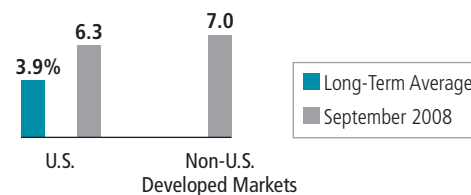
It's human nature: in challenging times, our emotions tell us to pull out of the markets and run for the hills. However, this creates two big problems. First, it's hard to see opportunities from far up in the hills. And second, when markets turn around, it can take too long to climb back down and get invested again.

## Lessons from the Past: Difficult Times Have Historically Brought Much Return Potential

### Yield Spread\* over 10-Year Government Bonds



### Equity Risk Premiums†



Historical and current analysis does not guarantee future results.

As of September 30, 2008

\*Option adjusted. Data begin January 2001 for global investment-grade corporates, August 2000 for global high-yield corporates and July 1999 for US CMBSs.

†Data begin in 1960.

Global investment-grade corporate bonds are represented by the Lehman Brothers Global Corporate Bond Index. Global high-yield bonds are represented by the Lehman Brothers Global High Yield Index. U.S. commercial mortgage securities are represented by the Lehman Brothers Commercial Mortgage-Backed Securities Index. Equity risk premiums are based on a proprietary model that relies upon the Standard & Poor's 500 Index and the MSCI EAFE Index. Individuals cannot invest directly in an index. Please see back cover for index definitions.

Source: Lehman Brothers and AllianceBernstein

## The Bear Eventually Hibernates...

Weak markets can be extremely challenging, but they eventually give way to recovery. And stepping out of the market can have severe consequences for your efforts to build wealth for the long term.

Take the last major bear market, which was triggered by the deflating technology bubble in early 2000. By September 2002, stocks had fallen 47% globally. Many investors undoubtedly felt the urge to walk away. However, stocks gained 25% over the following year, and 116% by the next peak in the market.

Selling during periods of market stress may cause you to feel the pain of loss twice: first, you lock in your losses; then you risk missing out on the market's eventual recovery. This can leave a hole in your savings that never really gets repaired—you'll always have less savings to build on than if you stayed the course.

## ...So Your Long-Term Strategy Shouldn't

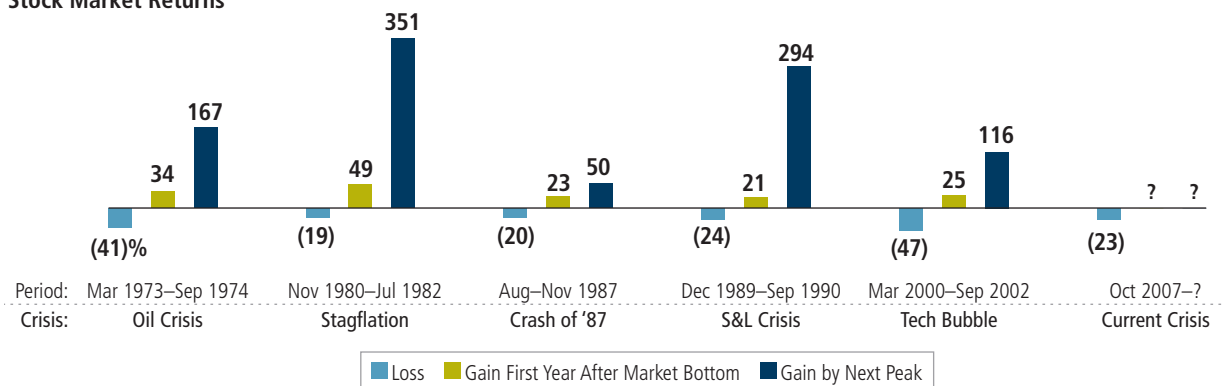
We're certainly not suggesting that it's easy to weather the storm. It means divorcing emotions from practical portfolio decisions. And it means a ticket to an upset stomach, especially when markets are gyrating, losses are mounting and doubts are swirling.

Instead of fighting an exhausting battle with your emotions, develop a diversified long-term strategy and stick to it. After all, your long-term goals don't change overnight—so why should your portfolio?

Work with your financial advisor to design—and maintain—an investment mix that makes sense for your long-term goals. Or consider investing in a diversified asset allocation portfolio that keeps you on track with automatic rebalancing. You'll rest assured that it'll keep working for you the way it was designed—and you won't stay awake at night.

### Been Here Before: Bear Markets Have Recovered

#### Stock Market Returns



Past performance does not guarantee future results.

Through September 30, 2008

Returns are calculated as growth of \$100 invested in the MSCI World Index starting from 1970 using month-end returns. Stocks are represented by the MSCI World. Individuals cannot invest directly in an index. Please see back cover for index definitions.

Source: FactSet, MSCI and AllianceBernstein

Diversification does not eliminate the risk of loss.



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Our investment services come in a variety of platforms to suit individual needs, including:

- Mutual Funds
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- Education Strategies
- Retirement Services

<sup>1</sup> As of September 30, 2008

<sup>2</sup> Institutional Investor News awards honor the organizations that made an impact on the financial services industry in 2005. Although nominations are solicited from the industry, award winners are researched and selected by the editorial staff. The breadth of the awards includes 10 categories, each with three nominees from across the global pension industry.



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- Exploring the opportunities and risks of the world's capital markets and the innovations that can reshape them

- Helping investors overcome their emotions and keep their portfolios on track
- Defining the importance of investment planning and portfolio construction in determining investment success

We've designed AllianceBernstein Research Insights as a foundation to help investors build better outcomes. Speak to your financial advisor to learn how we can help you reach your goals.

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**Diversification does not guarantee a profit or protect against loss.**

**Index Definitions:** The MSCI World Index is a free float-adjusted market-capitalization index that is designed to measure global developed-market equity performance. The Standard & Poor's 500 Index includes 500 U.S. stocks and is a common measure of the performance of the overall U.S. stock market. The MSCI EAFE Index (Europe, Australia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada. The Lehman Brothers Global Corporate Index is a subcomponent of the Lehman Brothers Global Aggregate Bond Index that covers the most liquid portion of the global investment-grade fixed-rate bond market including government, credit and collateralized securities. The Lehman Brothers Global High Yield Index provides a broad-based measure of the global high-yield fixed-income markets. The Global High-Yield Index represents

that union of the U.S. High-Yield, Pan-European High-Yield, U.S. Emerging Markets High-Yield, CMBS High-Yield, and Pan-European Emerging Markets High-Yield Indices. The Lehman Brothers Commercial Mortgage-Backed Securities (CMBS) Index tracks the performance of U.S.-dollar-denominated commercial mortgage-backed securities publicly issued in the U.S. domestic market.

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