[A|B] AllianceBernstein®

1Q 2019

AB VOLATILITY INSIGHTS

MARKETS SNAP BACK FROM TOUGH 4Q18

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Risk assets performed well during the quarter as central banks became more dovish, although government bond yields fell on the uncertain growth outlook. Volatility looks set to continue.

The market see-saw continued, with risk assets recovering sharply from the beating they took in fourth-quarter 2018 and finishing the first quarter of 2019 in positive territory. The outlook is for more of the same, and investors would be wise to position their portfolios accordingly.

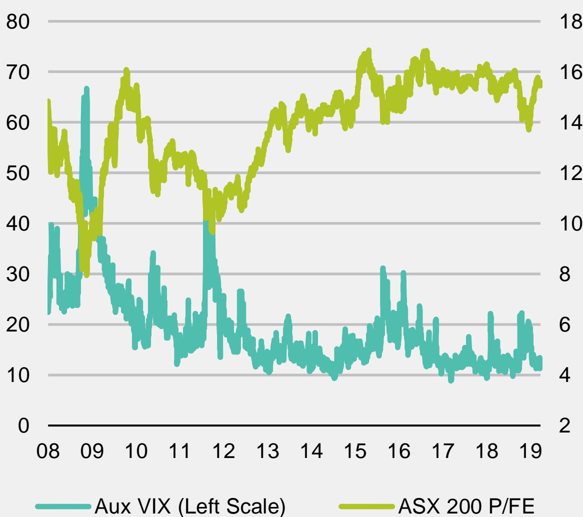
During the quarter, the MSCI World Index advanced by 12.6% in local currency terms, with stocks rising across regions and sectors and the US and Europe taking the lead among developed markets.

In fixed-income markets, most sectors posted strong returns and the Global Aggregate Index experienced its best three-month performance in two years. The uncertain growth environment pushed developed-world government bond yields steadily lower, even during periods when risk assets rallied.

The Australian S&P/ASX 300 Index ended the first quarter up 10.92% in local-currency terms. The Australian dollar rose by 0.90% against the US dollar, after official data revealed a sharp increase in the January trade surplus, which provided optimism even after other figures showed poor household spending growth in the new year.

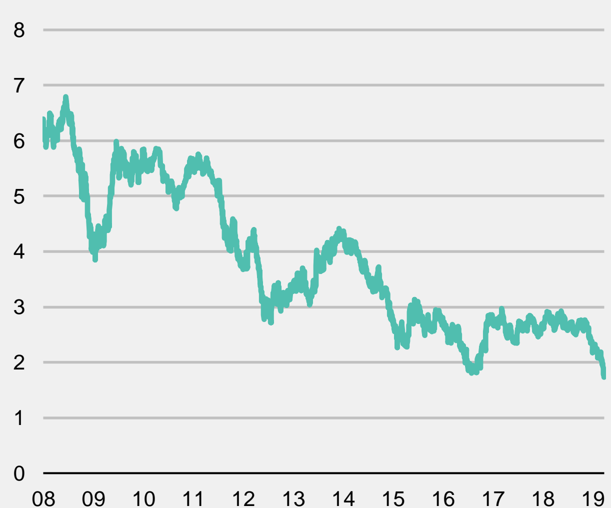
All sectors of the Australian index rose for the quarter, with the best performance coming from technology. The gap between

Display 1: High Valuations, Low Volatility (VIX[1]) Persist
VIX vs. S&P/ASX 200 P/FE Index



Historical analysis does not guarantee future results.
Through March 31, 2019
Source: FactSet

Display 2: Australian Yields Stay Low
10-year Government Bond Yield (%)



Historical analysis does not guarantee future results.
Through March 31, 2019
Source: FactSet

[1] The VIX or volatility index is designed to give a view of the share market's expectations of volatility over the next 30 days. It's essentially a record, in real time, of stock index option prices, and is inversely correlated to the underlying stock index. Put simply, a rise in the VIX signals an expectation of higher volatility in the underlying share market—historically, a reasonably reliable indicator that share prices are about to fall. Conversely, a fall in the VIX usually points to expectations of lower volatility and is regarded as a positive for underlying equities. For these reasons, the VIX has become popularly known as the "fear indicator" when it's high and the "complacency indicator" when it's low.

the Australian volatility index (VIX) and the price-to-forward earnings ratio of the S&P/ASX 200 Index remained wide **(Display 1, previous page)** while government bond yields, reflecting the uncertain growth outlook, fell **(Display 2, previous page)**.

DESPITE REBOUND, CONCERNS REMAIN UNRESOLVED

Much of the improved sentiment was driven by expectations of monetary policy, in our view. It's clear now that the US Federal Reserve and European Central Bank aren't about to put the brakes on by tightening monetary policy anytime soon.

In addition, last year's downturn reflected fears that some of the biggest challenges to the market would culminate in bad outcomes. The recovery suggests that investors felt the drawdown had gone too far. Now, global equities have nearly come full circle, and valuations are back close to similar levels seen at the end of September.

Despite the rebound, plenty of concerns remain unresolved. In late March, the inversion of part of the US yield curve and weakening European economic indicators added to anxieties about the global economy. China's slowdown, trade wars and Brexit are still casting a shadow over markets.

This helps explain why the ride back up hasn't been smooth. During the first three months of the year, global stocks rose or fell by at least 1% on six separate days. At this pace, the level of volatility this year might resemble that of 2018. With so many unresolved issues hanging over the global economy, investors should prepare for further volatility.

In Australia, the outlook—and, indeed, the central bank's concerns—have been increasingly shaped by the downturn in the housing cycle. While the Reserve Bank of Australia might want to see more concrete evidence of labour-market deterioration before cutting rates, it's likely also to consider the more dovish stance of its global counterparts when weighing up its next rates move.

SOME WAYS TO REDUCE PORTFOLIO VOLATILITY

We believe that Australian equity investors wishing to avoid too much volatility in their portfolios should look carefully at their exposures to banks and resources, which are both large weights in the S&P/ASX 300, but can be unattractive in terms of stability.

One solution might be more rigorous stock selection, and a reduction in weightings to these sectors; alternatively, investors can seek to mitigate the risks at the portfolio level by considering an actively managed, low-volatility strategy as part of their overall equities exposure.

Such a strategy, in our view, should include some scope for investing outside Australia, to diversify beyond the relatively concentrated (and frequently volatile) domestic market.

Our volatility-aware equity portfolios have had a lower beta than the market and attractive free cash flow. Our fundamental research insights aim to reduce our exposure to stocks with cyclical pressure, balance-sheet stress or negative events.

For fixed-income investors, one way to reduce volatility is to diversify beyond the Australian bond market by investing globally, across all sectors (such as government, corporate and asset-backed bonds), without reference to market indices.

Australia has a relatively small and concentrated bond market, and indices tend to be inherently volatile as they are weighted towards large borrowers, the extent of whose liabilities can be a source of volatility during market stress.

While corporate bonds performed well in the first quarter, it's difficult to see valuations improving significantly from current levels, and we have begun to trim our exposures. We have also begun to add government bonds back to the portfolio.

All returns and financial information are as of March 31, 2019. Source: Factset and AB

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