

Global Economic Outlook

March 2017

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Overview

Global Economy—The cyclical backdrop continues to brighten. If sustained, this will challenge the ultra-loose monetary policies of many central banks.

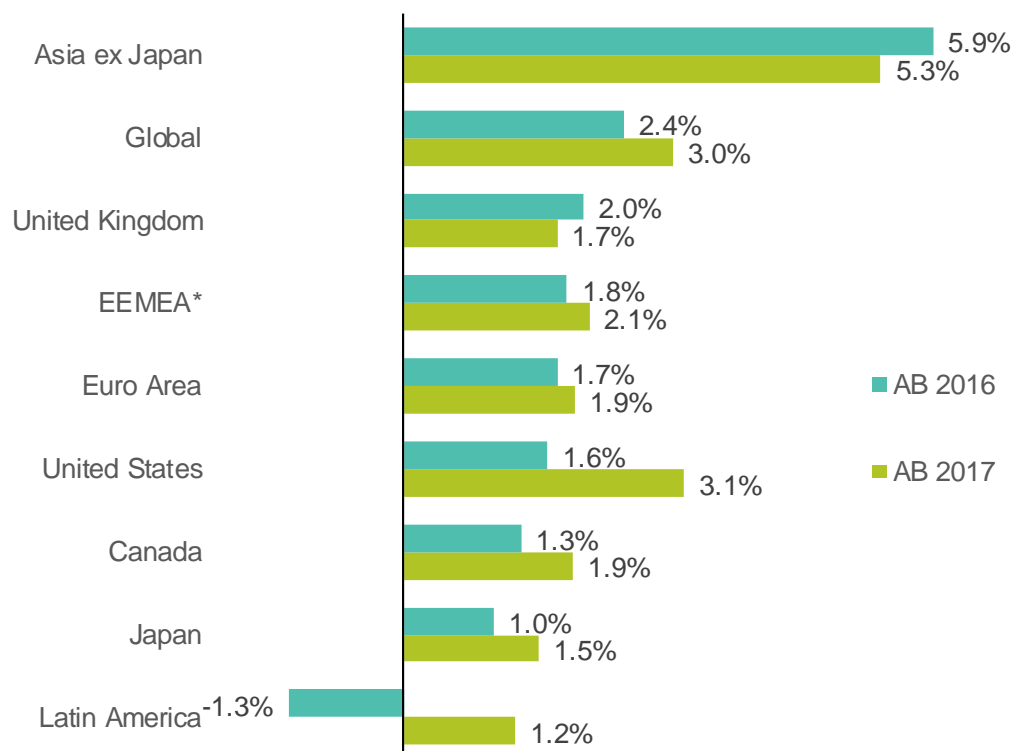
United States—Business surveys and labor-market data remain strong, while price pressures are building, suggesting that the Fed will keep normalizing rates.

Europe—The euro-area recovery is gaining momentum, and inflation is back at target. Core inflation is still soft, but early ECB tapering is now on the agenda.

Japan—It's steady as she goes for markets and the macro economy.

China—PBOC efforts to contain leverage have not succeeded in reining in credit growth. The central bank may need to increase its monetary-tightening efforts.

AB World Economic Growth Forecasts



As of March 1, 2017; calendar-year forecasts
 *Emerging Europe, Middle East and Africa
 Source: AB

Global Outlook

Brighter cyclical backdrop

For all the market's concerns about rising political risk—Trump in the US, the looming Dutch and French elections in Europe—the data continue to indicate that the global economy is enjoying something of a cyclical renaissance. This is evident in indicators such as the global manufacturing purchasing managers' index (PMI) that's currently at its highest level since June 2011), trade volumes and our latest global forecasts. We now expect the global economy to grow by 3.0% this year, up from 2.4% in 2016. Not only would this be its best performance since 2010, it would also be the first time since 2010 that we haven't been forced to revise our forecasts downward.

For sure, structural headwinds are likely to prevent global growth from returning to precrisis norms. But it's hard to avoid the conclusion that things appear to be in better shape than they have been for some time. As we've argued before, we attribute this to several factors, in particular a highly accommodative policy mix (monetary and fiscal), the likelihood that the worst of the deleveraging cycle is over in key developed economies (e.g., the US), and the absence of major negative shocks.

Plus rising inflation

Along with recovering growth comes rising inflation. For now, price pressures are being driven by developed markets, where inflation has climbed from 0.5% in the middle of last year to 1.9% today. Much of this has, of course, been due to rising oil prices and positive base effects from a year ago. Pushing inflation higher from here will be a much greater challenge and will depend upon multiple factors: fiscal delivery, how wages respond to tighter labor markets and whether central banks can engineer an upward shift in medium-term inflation expectations. The latter will be crucial when it comes to sustaining higher rates of inflation over the longer term.

Equals less accommodative monetary policy

But even if there are some doubts about the ability of central banks to generate higher inflation, the recent improvement in the cyclical backdrop and the increase in headline inflation should have an impact on central bank thinking. In particular, it may renew the debate about the risks of keeping monetary policy too loose for too long. The US Federal Reserve has already hinted that it will probably raise interest rates again in March. And while the European Central Bank (ECB) and Bank of Japan (BoJ) are likely to stick with their quantitative easing programs for now, pressure to rethink that strategy may start to build in the second half of the year if the current momentum is maintained. If it is—and if European political risk diminishes—the second half could be a more challenging period for bond markets.

US Outlook

Survey data surge

The US economy appeared to gain momentum in February, with survey data showing sentiment among both consumers and businesses marching steadily higher. The increase in small business sentiment has been particularly impressive, with the National Federation of Independent Business measure of small business optimism reaching its highest level since 2004. The improvement in sentiment reflected in the surveys has, however, not yet passed through to activity. The latest figures for both household consumption and business investment were tepid. We remain confident that over time, the activity data will move in the direction suggested by sentiment indicators, as is typically the case.

Labor-market strength

One reason for our optimism is the continued strength of the labor market. In February, initial claims for unemployment insurance fell to their lowest level in more than 40 years. Hiring intentions and other measures of employment remain strong as well.

Robust employment growth should underpin improved consumption going forward, particularly with consumer confidence near cycle highs.

Rate hikes to continue

Headline inflation moved sharply higher in year-over-year terms, largely reflecting base effects from past moves in energy costs. Core inflation moved up in a much more modest way. While we expect headline inflation to moderate in the months ahead, we think that core inflation will continue its steady march higher, and that conviction underpins our expectation that the Fed's rate-setting committee will raise rates at least two—or, more likely, three—times this year.

Europe Outlook

Gaining momentum

Recent data suggest that the euro-area recovery continues to strengthen. This is certainly true for the composite PMI, which rose from 54.4 in January to 56.0 in February. That's near a six-year high and broadly consistent with quarter-over-quarter GDP growth of +0.6%. If this is reflected in the actual data, it would represent a marked improvement on the second half of last year, when the economy grew at an average quarterly rate of +0.4%, and would be roughly double most estimates of the euro area's trend growth rate.

Back to target

The February data also showed another rise in headline inflation, to 2.0%, the first time it has been back at the ECB's target in more than four years. For now, the increase in inflation is being driven by energy prices (+9.2% in February) and, to a lesser extent, rising food prices. Indeed, food-price inflation has been surprisingly strong in recent months, rising to 2.5% in February from 0.4% in October, largely due to sharp increases in vegetable prices. By contrast, core inflation remains becalmed at 0.9%, not much different from the average in the second half of 2016 (0.8%).

Looking ahead, February's inflation rate of 2.0% is likely to be the peak for the year, and we expect the headline rate to slowly move back toward 1.5% between now and December. Two things could change this: another sharp increase in oil prices or a faster-than-expected pickup in core inflation. If the economy continues to build momentum, the risk of the latter will grow. For the time being, though, we think that the large output gap will continue to weigh on underlying inflation, and we expect core inflation to rise only gradually, to just over 1.1% by the end of the year.

Early ECB tapering?

If the economic backdrop continues to evolve in line with our expectations, it may create a dilemma for the ECB. The ECB is committed to buying €60 billion of bonds per month until at least the end of 2017. But with growth above trend and possibly accelerating and with inflation near the bank's target, the arguments for continuing to ease monetary policy are beginning to weaken (though soft core inflation means that the doves still have some ammunition). At the very least, we expect an announcement before year-end that the ECB will taper its bond purchases during the first half of 2018. We now see an enhanced risk that the ECB will start this process early and begin tapering before year-end.

First signs of softness in the UK

Having been surprisingly resilient in the wake of last year's Brexit vote, the UK economy may now be exhibiting signs of beginning to soften. In January, retail sales failed to bounce back from December's 2.2% drop and therefore are running well below fourth-quarter levels. And in February, the manufacturing and services PMIs slipped back, pushing the composite index down to 53.8 from 55.4 in January. Although the read across from the PMI to GDP growth is not strong in the UK, this would be broadly consistent with quarter-on-quarter GDP growth of +0.4% (for comparison, the economy grew at an average +0.6% per quarter in the second half of last year). In light of this,

we remain comfortable with our view that the Bank of England will resist pressure to tighten policy as inflation moves toward 3.0% in the coming months.

Japan Outlook

Little change in markets or the macro situation

Japanese markets have moved sideways since the start of the year. This may be because there's a greater degree of certainty in Japan than elsewhere. The BoJ, for instance, carried out new fixed-rate purchase operations in February and announced a more concrete schedule for Rinban operations. For now, that has strengthened the market's confidence in the BoJ's ability to maintain the yield-curve control program.

More generally, there has been no change in Japan's macroeconomic situation, and markets are still waiting for clarity on some important issues. Domestic macroeconomic data have been consistent, pointing to modestly above-potential growth, including a gradual rise in headline inflation.

Waiting for clarity on Trump's fiscal boost

We are still waiting for clarity on three things. The first is US economic policy, particularly the nature of the trade barriers sought by the Trump administration. Japan is vulnerable to more protectionist policies because it runs a large current account surplus (just shy of 4% of GDP) and a large bilateral trade surplus with the US.

Second, it's still not clear that the government's fiscal measures are gaining traction. The latest National Accounts data show that public sector investment remains soft. So far, there doesn't even seem to be an indirect effect via crowding in of private sector capital expenditures or faster wage growth. To boost growth and inflation expectations, this will have to change.

Finally, as we've discussed before, it's still possible that the BoJ will consider pulling back slightly from its QQE-YCC program before the end of the year. The chance of that happening in the near term is slim, but speculation is likely to increase as we roll into 2018.

Australasia Outlook

Optimism rises, but housing risks loom

Economic data in Australia, including indicators of business sentiment, have been stronger than expected over recent months. Even so, we are growing more worried about the outlook for the housing sector.

First, the surge in construction activity is now tilting the supply/demand balance toward oversupply in certain important pockets of the market. That's evident in very weak growth in residential rents and is likely to intensify in coming quarters as more building projects are completed. Second, it's becoming harder for foreign buyers to access the Australian market. China's stringent capital outflow restrictions, Australia's tightening of domestic lending criteria to foreigners and differing tax regimes are all contributing to this. Third, we expect the 2014 directive that limits the growth of lending to investors to 10% to be tightened even further.

Add in high debt levels, stagnant wages and a declining savings rate, and it's easy to be more pessimistic about Australian housing. We still expect a weaker economy, a softer Australian dollar and renewed rate cuts as the year progresses.

Canada Outlook

Evidence of improving consumer strength

Domestic and external factors are pulling Canada in different directions. Economic data in February continued to exceed expectations. The labor market continues to add jobs. Home sales remain strong despite various federal and provincial regulations. Year-over-year retail sales have increased. All this suggests that Canadian consumers are doing well, or at least better than they have been in recent years. Fourth-quarter GDP, though a lagging indicator, tells a similar story, with real GDP growing at 2.6%, well above the 2.0% consensus expectation.

US trade policy could act as external shock

But there's a dark cloud looming over the economy, and it's coming from abroad. A disorderly renegotiation of NAFTA—a priority of the new US administration—would have negative effects throughout the Canadian economy, since many industries are deeply dependent on US trade flows. Prime Minister Justin Trudeau and Finance Minister Bill Morneau both take a cautiously optimistic tone when discussing pending negotiations, while Bank of Canada (BoC) governor Stephen Poloz is more negative on the outcome of US trade policy. Over the past few months, the BoC statements have been dovish and signaled that the central bank would keep monetary policy accommodative to protect against potential negative shocks to trade.

Uncertainty to persist in the near term

We tend to think that the sunnier outlook is more plausible. We expect NAFTA negotiations to be orderly and mutually beneficial for Canada and the US. Improving domestic conditions and favorable trade policy should allow the BoC to tighten policy at the end of 2017, in our view.

But the outlook will remain uncertain until we get more clarity on US policy. Until then, expect further depreciation of the Canadian dollar and a more dovish BoC.

Emerging-Market Outlook

Latin America: Emerging-market funds saw inflows again in February as global investors put aside talk of potentially disruptive US trade policies.

Mexico: Preemptive policies galore

Mexico's Exchange Commission announced a US\$20 billion currency hedging program "to ensure the orderly functioning of the FX market." This comes after the peso exhibited high volatility "not consistent with the country's economic fundamentals." The policy is geared toward providing hedging ability to investors without affecting central bank reserves; the transactions will be settled in pesos. Banco de Mexico will auction the hedges to local banks (by selling USD/MXN non-deliverable forward contracts). The banks, in turn, will offer them to different market participants. The first auction for up to US\$1 billion was scheduled for March 6, with subsequent size and timing of transactions to be determined by market conditions. The swap contracts will have tenors of up to 12 months. The commission also indicated that "additional actions" could be forthcoming, including swaps or other instruments used in the past (e.g., direct use of reserves).

The structure of the program is welcome because it will allow the authorities to stabilize the currency without affecting the country's stock of foreign exchange reserves. While Mexico has doubled its reserves since the global financial crisis and secured a flexible credit line with the International Monetary Fund (IMF), the reserves that can be used for intervention are limited. The new program could generate a deficit if the currency weakens.

The plan echoes Brazil's intervention mechanism. The upper limit to Mexico's program may be too restrictive, though, if there's a sudden negative shock, whether it's an unexpected negative tweet from the White House or a US announcement of new protectionist measures. While US\$20 billion amounts to roughly two-thirds of Mexico's annualized current account deficit, it is a small portion of the nearly US\$100 billion in daily traded volume in the Mexican peso. So if volatility spikes, the program ceiling may have to be lifted.

The peso strengthened after the program was announced, with the USD/MXN rate slipping below 20. The program also gives Bank of Mexico governor Agustín Carstens more monetary-policy flexibility since the new tool will complement rate hikes to stabilize the currency. The bank recently confirmed that Carstens will remain at the helm until November 30, after which he will join the Bank for International Settlements. Carstens, a familiar face who has won the trust of markets, had been expected to leave in July. Keeping him on longer could prove important if the US introduces new taxes on trade or charges any trading partners as currency manipulators.

Commodity prices fuel export recovery

Asia ex Japan: A recovery in nominal energy and other commodity prices has led to improved export growth for most regional exporters. Beyond prices, though, the recovery in exports remains fairly tepid. Taiwan and, to some extent, China are the exceptions. In these countries, semiconductors and smartphone production have driven a recovery in export volume. Taiwan gained market share and captured more high-value-added work that migrated to its shores from regional competitors. But this driver is specific to product and supply chains and has a limited pass-through to the broader economy.

PMI suggests that momentum could soon peak

Meanwhile, forward-looking indicators such as PMI readings have been mixed. That suggests that the electronics cycle could soon peak. Across the region, Taiwan remains the outperformer, but headline PMI has slackened over the past two months. South Korea experienced limited improvement, though the PMI is still at contractionary levels. Only China registered a clear pickup in the index, driven by higher nominal revenue and profits for the upstream materials and resources sectors. Large enterprises—most of them state-owned—have shown the most improvement. Exports by smaller, mostly private sector, companies continue to weaken.

Export recovery boosts currency performance

The Taiwan dollar has been the main beneficiary of the current semiconductor cycle, but investors should be on the lookout for the cycle peak. South Korea's strong nominal export growth mainly reflects the commodity price factor. But improvement in the headline number should make the Bank of Korea comfortable with currency appreciation, especially considering market concerns that the US may name some Asian exporters as currency manipulators. In China, political decisions will likely have more influence on the yuan at a time when stability seems to be the main objective.

China's credit growth still too strong

Chinese data on credit in January were strong, despite efforts to contain systemic leverage. Credit demand tends to be stronger during the Chinese New Year period. Even so, we are cautious about a surge in shadow credit for the past three months. Sector-specific tightening measures were supposed to contain such growth. We think that the shadow credit growth has fed speculation in commodities and put downward pressure on the yuan.

Meanwhile, mortgage growth remains strong, and the level of household debt is not particularly high. But the staggering pace of mortgage growth is a concern. We expect the People's Bank of China (PBOC) to tighten policy further to rein in credit expansion.

Capital outflow persists

On the other hand, China's foreign reserves declined by US\$12 billion in January and now stand at slightly less than US\$3 trillion. We think that China will need to do more to stop the outflows and encourage portfolio inflows. This could affect Chinese investment demand in offshore markets.

Housing risk not highlighted

Markets are also focused on Premier Li's economic plan for 2017. Announced recently, the plan sets a 6.5% growth target for the year. This implies that Beijing will not let growth slip too far. The fiscal target remains at 3% of GDP as of last year, which means that fiscal policy will not be as expansive as most market participants thought. Housing was not included with nonperforming loans, shadow credits, bond default and Internet financing as a risk. This is a break from the Party's proposal late last year. On the surface, the plan appears to endorse a continuation of regionally specific measures to deal with different housing problems in different parts of China. At this point, it's unclear what types of measures might be implemented.

Trump's uncertain Middle East policy

Emerging Europe, Middle East and Africa: The net effect of the new US administration's Middle East policy remains ambiguous, to say the least. From Israel's viewpoint, the country certainly benefits from greater bilateral US support and certainly backs more vigilance when it comes to Iran. That said, President Trump's suggestion to find an alternative to the two-state solution creates a policy vacuum and stokes geopolitical uncertainty. This comes at a time when Israel's continued push for settlement construction and this year's parliamentary decision to legalize the expropriation of privately owned Palestinian land risk worsening relations with some of its neighbors.

Despite risks, Israel benefits from a strong external balance sheet...

Despite the geopolitical risks, Israel's macroeconomic backdrop has been improving. The country's main macro strengths are its status as a large external creditor and an open economy supported by a competitive high-tech export sector. The discovery of major gas fields off the Mediterranean coast significantly improved Israel's energy independence, which has been further strengthened by the fall in global oil prices. Against this backdrop, Israel has managed to run a current account surplus in excess of 3% of GDP since 2013, hitting a recent peak of 4.6% in 2016. The Bank of Israel has been steadily building up international reserves against a strong current account and large capital inflows, a mix of both portfolio and FDI flows. International reserves were up almost 30% in dollar terms between 2010 and 2016. Furthermore, total external debt was likely less than 28% of GDP in 2016, more than a third lower than the ratio observed in 2010, while sovereign external debt was likely less than 15% of GDP in 2016 (down from about 23% in 2010). We believe that Israel's external balances are likely to remain robust over the coming years, underpinned by prudent external debt management and ongoing large current account surpluses, with higher global oil prices likely offset by rising Israeli gas production and, eventually, exports.

...and prudent public debt management

Domestically, Israel's relatively prudent fiscal policy and conservative public debt management are key strengths, although rising private sector leverage and increasing house prices pose risks. Israel's public sector debt ratio has decreased noticeably (to about 63% of GDP in 2016 from 74% of GDP in 2010), against mostly small primary budget surpluses, strong real growth and relatively steady real interest rates. Nominal fiscal deficits are expected to rise closer to 3% of GDP over the coming two years against proposed corporate tax cuts, but fiscal rules set by statutory law will continue to prevent more significant increases in deficits.

Given Israel's elevated GDP per capita, overall private sector debt levels among both households and nonfinancial corporates remain manageable, compared with similarly rated countries. But record-low interest rates have fueled a faster increase in household leverage—in particular, mortgage debt—over the past six years. Aside from

supply constraints, this has also helped to sustain noticeable increases in domestic house prices, which have climbed by 6%–7% annually since 2012 and 10%–15% between 2009 and 2011. While unlikely to pose systemic risks, the expected normalization in domestic interest rates from 2018 onward may lead to a cooling in the housing market and an associated rise in nonperforming loan ratios. Against already-stretched income/ house price ratios, this may pose a constraint on real growth in the medium term.

Ecuador moves to the right

Frontier Markets: As many developed markets move toward populist regimes, at least one frontier market is moving away from the “pink tide” that swept Latin America in the early 2000s. In Ecuador’s presidential election on February 19, Lenin Moreno, the handpicked successor of sitting leftist president Rafael Correa, failed to secure enough support to avoid a second round of voting (Correa was not on the ticket for the first time in 10 years). That means that Moreno will face off with opposition candidate Guillermo Lasso in an April 2 runoff. Lasso is clearly the market’s preferred candidate. And he’s projected to win, thanks to support from other opposition groups aligned against Moreno. Although Lasso will attempt to impose pragmatic policies and request IMF support to improve institutions, altering the country’s bleak economic outlook will still be a major challenge.

	Real Growth (%)		Inflation (%)		Official Rates (%)		Long Rates (%)		FX Rates vs USD	
	2016F	2017F	2016F	2017F	2016F	2017F	2016F	2017F	2016F	2017F
Global	2.4	3.0	2.0	2.9	2.37	2.40	2.91	3.30	-	-
Industrial Countries	1.7	2.4	0.8	2.1	0.39	0.78	1.41	2.10	-	-
Emerging Countries	3.8	4.0	4.2	4.3	6.17	5.52	5.81	5.60	-	-
United States	1.6	3.1	1.2	2.9	0.63	1.63	2.45	3.50	-	-
Canada	1.3	1.9	1.6	2.5	0.50	0.75	1.72	2.75	1.34	1.38
Europe	1.8	1.9	0.4	1.8	0.04	0.04	0.46	0.97	-	-
Euro Area	1.7	1.9	0.3	1.8	0.00	0.00	0.22	0.75	1.05	1.05
United Kingdom	2.0	1.7	0.7	2.5	0.25	0.25	1.28	1.75	1.23	1.20
Sweden	3.6	2.8	1.1	1.5	(0.50)	(0.50)	0.55	1.00	9.08	8.90
Norway	0.8	1.6	3.2	2.5	0.50	0.50	1.70	2.00	8.61	8.57
Japan	1.0	1.5	(0.2)	0.7	(0.03)	(0.10)	0.04	0.10	117	125
Australia	2.3	1.9	1.2	1.7	1.50	1.00	2.76	3.00	0.72	0.72
New Zealand	3.2	3.0	0.6	1.5	1.75	1.75	3.36	3.25	0.70	0.71
Asia ex Japan	5.9	5.3	2.3	2.6	3.37	3.70	3.58	4.14	-	-
China	6.7	5.8	2.0	2.5	3.34	3.90	3.02	3.80	6.94	7.05
Hong Kong	1.9	2.7	2.6	2.1	0.75	1.50	1.97	2.30	7.75	7.76
India	7.0	6.2	4.9	3.2	6.25	6.25	6.52	7.20	67.92	65.50
Indonesia	5.0	5.2	3.5	4.3	4.75	4.50	7.97	7.60	13436	13000
Korea	2.7	2.3	1.0	1.5	1.25	0.75	2.09	1.80	1204	1180
Thailand	3.2	2.7	0.2	1.8	1.50	1.50	2.65	3.20	35.81	35.50
Latin America	(1.3)	1.2	5.5	6.4	11.83	8.80	9.16	6.98	-	-
Argentina	(1.8)	2.5	-	22.0	24.75	20.00	-	-	15.90	17.00
Brazil	(3.5)	0.9	9.0	4.9	13.75	9.50	11.36	9.80	3.25	3.50
Chile	1.7	2.0	4.0	3.2	3.50	3.00	4.29	4.50	667	680
Colombia	2.2	2.0	7.6	4.2	7.50	6.25	7.12	7.20	3001	3020
Mexico	2.2	1.8	2.8	4.5	5.75	6.75	7.25	7.80	20.62	21.00
EEMEA	1.8	2.1	6.3	6.4	7.75	6.99	8.96	8.61	-	-
Hungary	2.0	2.6	0.4	2.4	0.90	0.90	3.16	3.80	294	313
Poland	3.1	3.2	(0.6)	2.0	1.50	1.50	3.63	4.00	4.18	4.40
Russia	(0.6)	1.1	7.2	5.3	10.00	8.50	8.46	9.00	60.66	60.50
South Africa	0.3	1.1	6.4	5.9	7.00	6.50	8.92	9.50	13.70	13.73
Turkey	3.3	1.8	8.4	9.2	8.00	8.75	11.10	11.30	3.52	3.83

Real growth and inflation are calendar-year forecasts. Official and long rates are end-of-year forecasts.

Long rates are 10-year yields unless otherwise indicated.

Latin American Inflation and Rates include Brazil, Chile, Colombia and Mexico

Real growth aggregates represent 31 country forecasts not all of which are shown

Blanks in Argentina are due to distorted domestic financial system so are not forecast.

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