

AllianceBernstein— Emerging Markets Debt Portfolio

Market Overview

Dollar-denominated emerging-market debt benefited from another very strong month in September. The JPMorgan Emerging Market Bond Index Global (EMBI) advanced 1.72% for the month and 16.11% for the year to date.

Dollar-denominated emerging-market debt performed strongly during October. Ecuador was the top-performing country during the month, after being the worst performer in September. Argentina advanced 13.84%, with prices rising after the death of former President Nestor Kirchner. Investors are hoping that a more productive and reform-minded dialogue can now begin within the country.

Kazakhstan was the worst-performing country due to fears that a partial privatization of KazMunaiGas (KMG), the state owned oil and gas company, will force its removal from the JPMorgan sovereign emerging indexes. This could lead to forced selling by index tracking investors. During the month, the Kazakhstan sub-index fell 1.61%, with the yield spread widening 38 b.p. The only other countries with negative returns were Belarus and Malaysia.

Corporate emerging-market debt underperformed sovereign emerging-market debt, according to the JPMorgan Corporate Emerging Market Bond Index Broad (CEMBI

Broad). The yield spread on this index narrowed just 12 b.p. during October. There was heavy new issuance into the market, which is likely leading to modest relative underperformance.

Additional quantitative easing (QE) by the US Federal Reserve (Fed) is dominating debate within the global financial markets. The Fed announced in early November that it will purchase an additional \$600 billion of US Treasury securities by the middle of 2011. Central bankers and fiscal authorities in a variety of emerging and developed-market economies criticized the policy as an attempt to weaken the US dollar, thus increasing the risk of a currency or trade war.

The Fed is responding to a slow recovery in the US economy, continued high unemployment and concerns that deflation is a greater threat than inflation. But QE is an unorthodox and blunt tool that has rarely been used and thus has an uncertain outcome. The Fed's policy should keep market rates in the US low, maintain ample liquidity in the global financial markets and boost investor confidence of a sustained recovery in global growth. QE should encourage continued inflows into emerging-market economies, creating a possible policy dilemma and further distortion in prices between domestic and off-shore markets.

Capital inflows foster credit growth and increase domestic demand, which puts upward pressures on inflation. In normal times this should result in a tightening of monetary policy. Unfortunately higher domestic interest rates would encourage additional inflows and thus can prove counter-productive. The correct response to reduce domestic demand and inflation pressures would maintain interest rates at current levels and tighten fiscal policy. Few countries appear ready for this policy mix.

Instead, policymakers in a wide range of countries are using various capital controls and taxes to discourage "hot money" inflows. While we are sympathetic to policymakers' concerns in a few emerging-market economies, we think widespread use of capital controls is unjustified and potentially dangerous. There is little justification for countries running a current account surplus or a small deficit to take great efforts to limit capital inflows in order to limit currency appreciation.

The demand for emerging-market country currencies has driven the implied yields on offshore non-deliverable forwards to a record low of 2.5%, year-to-date, according to the JPMorgan Emerging Local Market Index+. There is also a significant gap between domestic and offshore yields in China,

Colombia, Indonesia, South Korea, the Philippines and Peru. In some cases investors are willing to pay a negative interest rate to gain exposure to specific currencies. This situation could worsen as additional capital controls are implemented.

Portfolio Performance

The Portfolio outperformed its benchmark, the JPMorgan Emerging Market Bond Index Global (EMBI), during the month and underperformed for the year to date. The benchmark returned 1.72% for the month and 16.11% for the year to date.

Country selection drove portfolio performance, driven by our overweight position in Argentina and underweight positions in Malaysia and Lebanon. Negative factors were our overweight positions in Kazakhstan and Russia, along with an underweight in Iraq.

Security selection was neutral during the month. Positive returns from our holdings in Kazakhstan,

Columbia and Turkey balanced weakness from our holdings in Argentina.

Outlook and Strategy

During October, we increased the portfolio's exposure to Argentina. Looking forward, we do not expect to alter the overall risk exposure to the portfolio. Capital controls are a risk and create an increased uncertainty.

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