# "...it was the season of hope; it was the winter of despair..." –Charles Dickens, *A Tale of Two Cities*

October 2011

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Senior Vice President, Chief Investment Strategist
Charles Schwab & Co., Inc.

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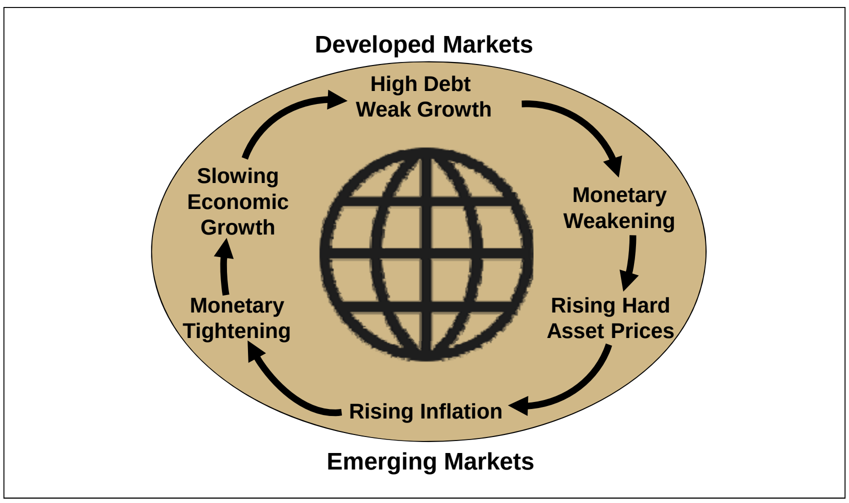
## A Vicious Circle

Could be Broken in Lower Half

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Hard assets include commodities and precious metals. Source: Windhaven Investment Management.

## The Bears' Case

- "Stall speed" in economy … elevated recession risk
- Eurozone debt crisis … 2008 redux?
- US debt crisis … nasty political scene
- Debt deleveraging cycle depresses growth & lasts a long time
- Volatile stock market becoming catalyst vs. discounter?
- ECRI leading index / economist calling for new recession
- Fed out of traditional bullets, hence "Operation Twist" (pushing on string?)
- Anemic jobs & real estate recoveries
- Slowing global growth
- Corporate margin pressure & weakening forward earnings guidance
- Confidence crisis = self-fulfilling prophecy
- Fiscal restraint draining economic growth





## The Bulls' Case

- Still-strong consumer-driven growth in emerging economies
- Real GDP could reach 3% in third quarter
- Exceptionally low expectations bar
- "Operation Twist" to lower borrowing/mortgage rates (help for refinancings)
- Strong corporate profits / $2.1 trillion cash on corporate balance sheets
- Leading indicators for job growth remain healthy
- Lift to auto sector from Japan's recovery
- Credit markets on the mend; lending starting to grow again
- Tax reform on table
- Commodity prices down from peak; global monetary tightening ending
- Inexpensive valuation on forward earnings
- Extreme investor pessimism (contrarian indicator)

## ECONOMY: STALL SPEED & RECESSION RISK

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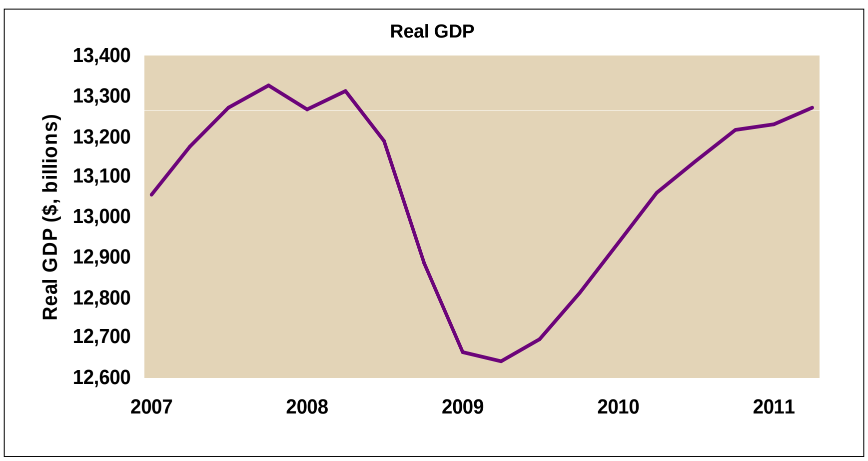
## A “Square Root” Shaped Recovery Unfolding

Our Initial View When Estimating Recession Was Over in Mid-2009




As of 2Q11. Source: Bureau of Economic Analysis, FactSet.

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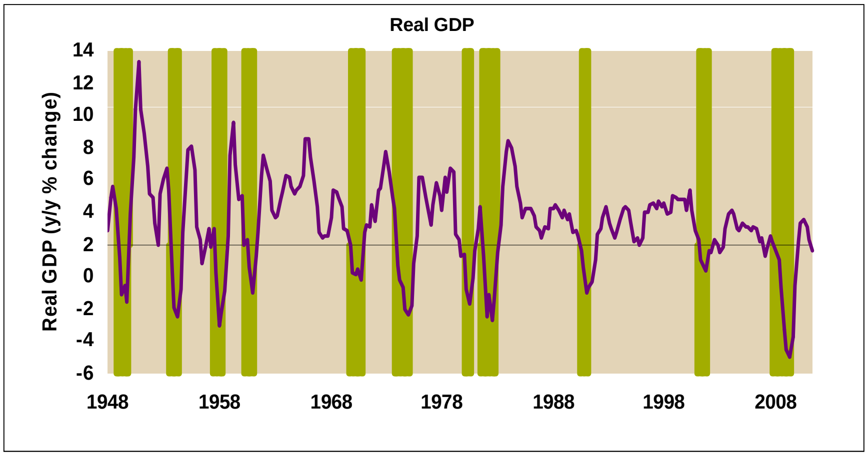
## GDP's Y/Y Growth Dips Below 2%

"Stall Speed" Raises Likelihood of Recession




As of 2Q11. Green-shaded areas indicate periods of recession. See last slide for definition of recession. Source: Bureau of Economic Analysis, FactSet, National Bureau of Economic Research (NBER).

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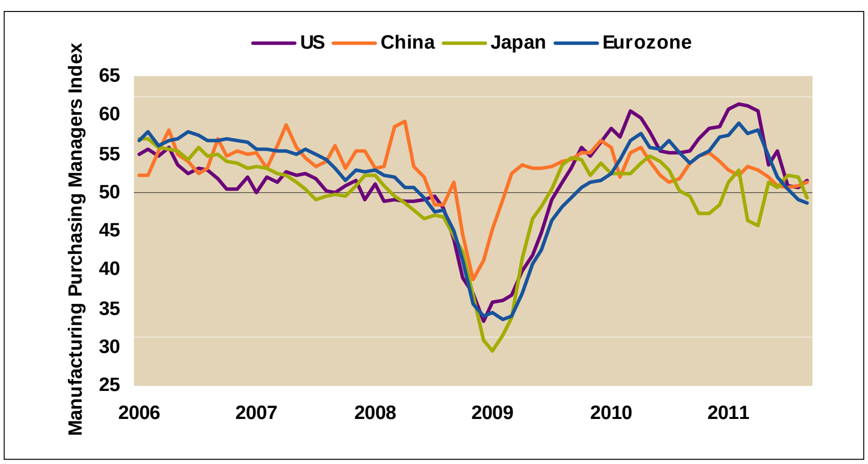
## Growth Slowdown is Global

But Monetary Easing Might Help




As of 9/11. A reading above 50 indicates that the manufacturing economy is generally expanding; below 50 indicates that it is generally contracting. Source: Bloomberg, FactSet.

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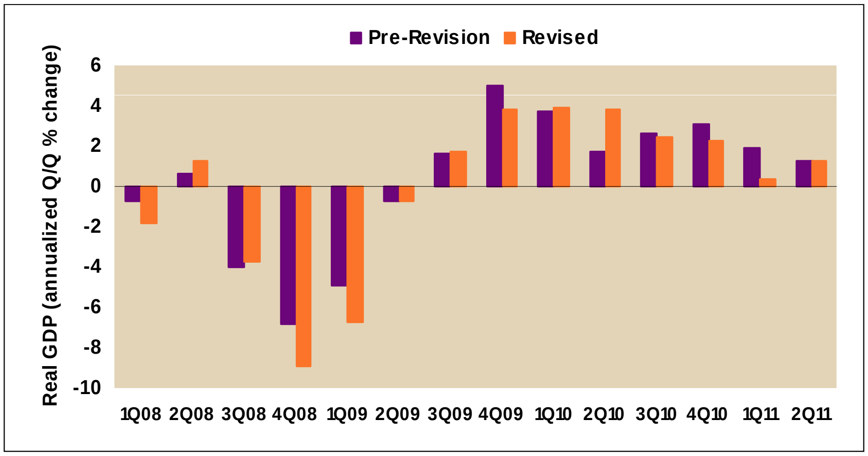
## Real GDP Worse Than Originally Thought

Nominal GDP Actually Higher, But So Was Inflation





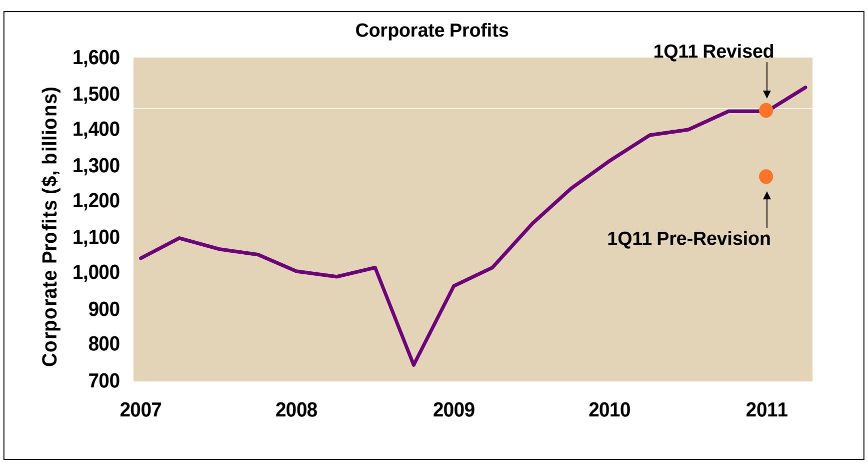

As of 2Q11. Source: Bureau of Economic Analysis.





## Corporate Profits Revised Up By Whopping 15%

Bright Spot Among GDP's Revisions (Helped by Higher Inflation)

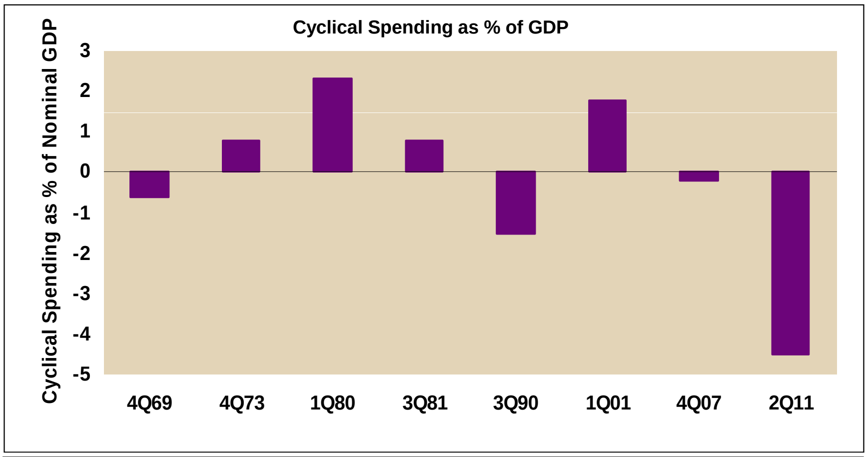





As of 2Q11. Corporate Profits are after tax with inventory valuation and capital consumption adjustments. Source: Bureau of Economic Analysis, FactSet.

## A Coiled Spring & No Recession Signal

Cyclical Spending Has Never Been This Low Pre-Recession




**Cyclical Spending = consumer durables, business equipment and software, residential investment, nonresidential spending**

As of 2Q11. Cyclical spending (consumer durables, business equipment and software, residential investment, nonresidential investment) based on relative to average from 1970. X-axis labels represent start of prior periods of recession (with exception of current 2Q11 period which is not a period of recession). See last slide for definition of recession. Source: BCA Research, Inc., Bureau of Economic Analysis, FactSet, National Bureau of Economic Research (NBER).

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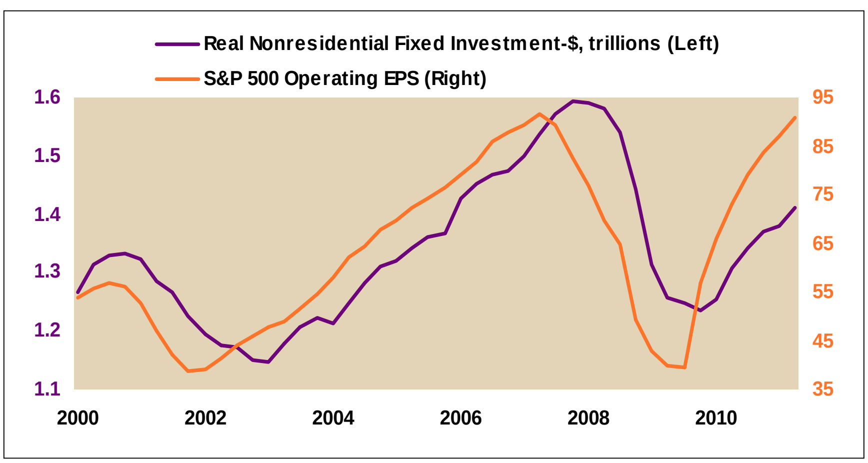
## Investment Has Undershot Corporate Earnings

Means Are There, But Not Motivation … Yet

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As of 2Q11. Source: BCA Research, FactSet, Standard & Poor's.

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## CONSUMERS & BUSINESS: HEALTH, WEALTH & CREDIT

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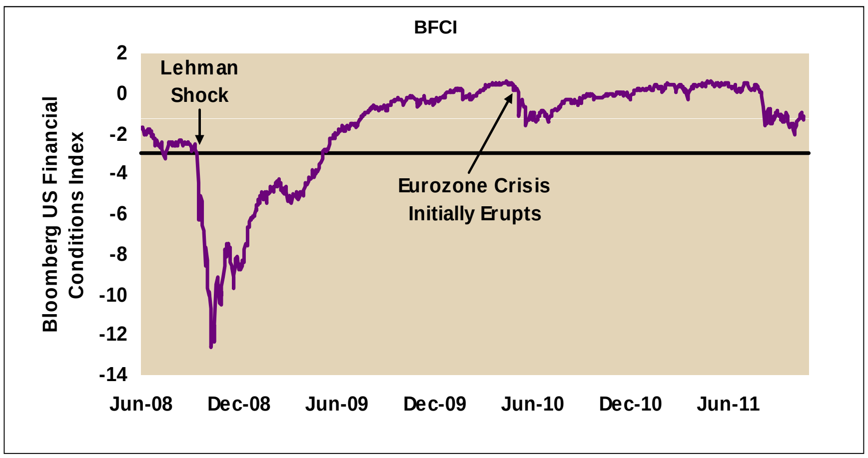
## Credit Conditions Healthier

Eurozone Debt Crisis Not Like Subprime/Lehman Plague of 2008




**The BFCI combines yield spreads and indices from the short-term debt markets, equity markets and bond markets into a single normalized index.**

As of 10/20/11. Y-axis values are z-scores which represent the number of standard deviations that current financial conditions lie above or below the average of the 1994-2008 period. Source: Bloomberg.

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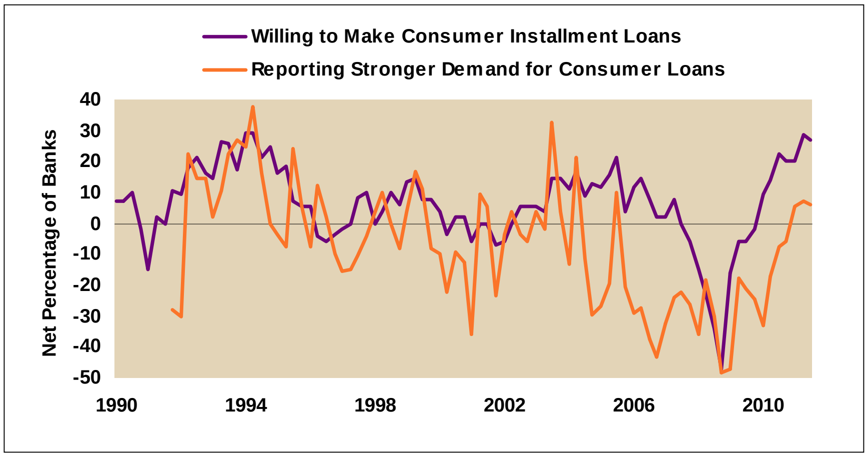
## Consumer Loan Supply/Demand Improving

Both Remain in Positive Territory Even After Latest Dip




As of 3Q11. Average of changes in demand for credit card loans, auto loans, and consumer loans excluding credit card and auto loans used to calculate consumer loans data beginning in 2Q11. Source: FactSet, Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices.

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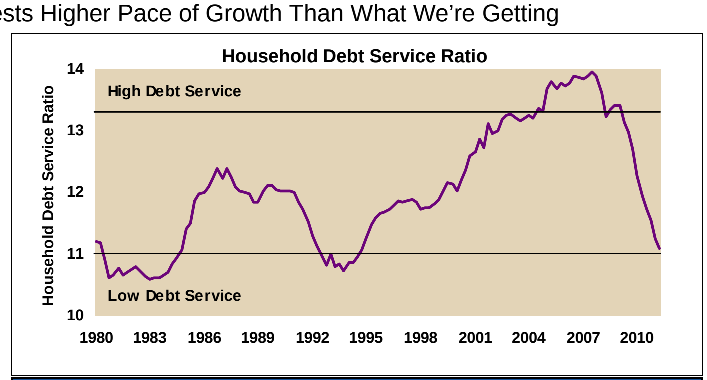
## Private Sector Began Deleveraging in 2008

Suggests Higher Pace of Growth Than What We're Getting




| 3/31/1980-6/30/2011 | | | |
|---|---|---|---|
| Debt Service Ratio | Nominal GDP Annualized Gain | Real GDP Annualized Gain | Nonfarm Payroll Annualized Gain |
| > 13.3% | 3.4% | 0.8% | -0.1% |
| 11%-13.3% | 5.4% | 2.7% | 1.2% |
| < 11% | 7.9% | 3.5% | 2.0% |

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As of 2Q11. Household Service Debt Ratio is an estimate of ratio of required debt payments to disposable personal income. Required minimum payments of interest and principal on outstanding mortgage and consumer debt are included. Source: FactSet, Federal Reserve, *Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission.* 

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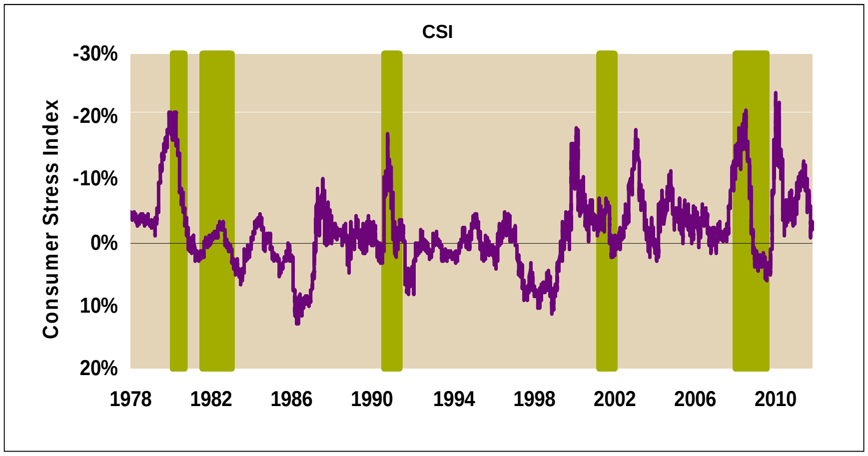
## Consumers' Stresses on Volatile Path

Lower Commodity Prices Helping Recently




**"Consumer Stress Index (CSI)" = average year-over-year % change of S&P 500 Index, non-farm payrolls, real DPI, median home price; and inverse of oil price, medical care inflation, household liabilities and CRB Foodstuffs Index.**

As of 10/20/11. Data plotted on inverted scale. DPI represents disposable personal income. Median home price component based on new and existing single-family homes. Medical care component taken from Consumer Price Index. Green-shaded areas indicate periods of recession. See last slide for definition of recession. Source: FactSet, National Bureau of Economic Research (NBER).

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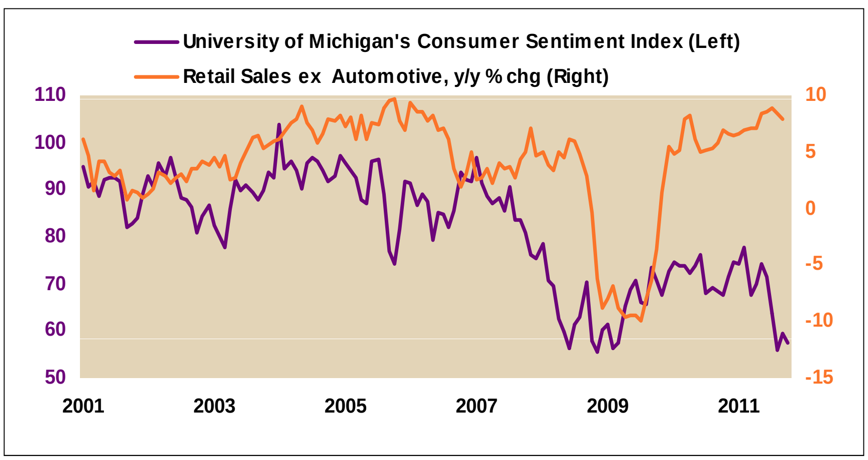
## Say vs. Do

Gap Between What Consumers Say & Do Has Never Been Wider

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Consumer Sentiment as of 10/11. Retail Sales as of 9/11. Source: Census Bureau, FactSet, High Frequency Economics (HFE), University of Michigan.

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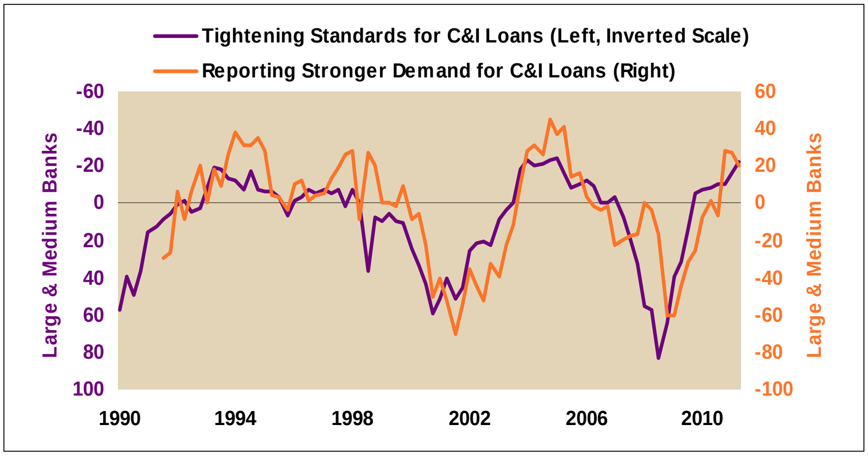
## C&I Loan Supply/Demand Improving

Supply Lines Have Opened Further & Demand Remains Positive



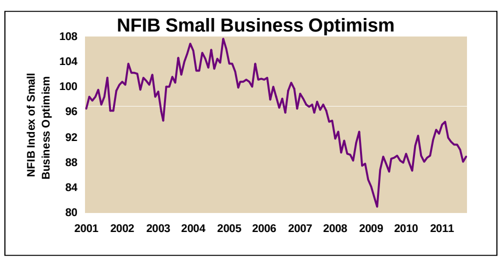

As of 3Q11. C&I=commercial & industrial. Source: FactSet, Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices.

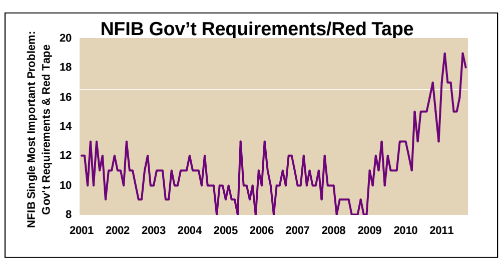




## Small Business Remains Pessimistic

Huge Surge in Gov't Red Tape as Key Reason




As of 9/11. Source: FactSet, National Federation of Independent Business (NFIB).

# GOV'T SECTOR DELEVERAGING: JUST BEGINNING

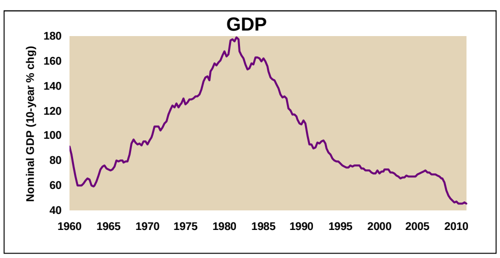


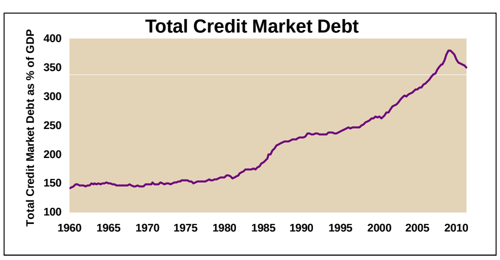




## GDP's Strength Waned …

… As Debt Growth Surged … But Debt Growth is Finally Ebbing




As of 2Q11. Source: Bureau of Economic Analysis, FactSet, Federal Reserve.

# 90% Debt/GDP = Threshold Above Which GDP Suffers

US Federal Debt Presently 96% of GDP

| Real GDP Growth as Level of Government Debt Varies | | | | |
|---|---|---|---|---|
| **Select Advanced Economies (1790-2009)** | | | | |
| | Central (Federal) Government Debt/GDP | | | |
| | Below 30% | 30% - 60% | 60% - 90% | 90% and Above |
| Average | 3.7 | 3.0 | 3.4 | 1.7 |
| Median | 3.9 | 3.1 | 2.8 | 1.9 |
| # of Observations | 866 | 654 | 445 | 352 |
| **Select Emerging Market Economies (1900-2009)** | | | | |
| | Central (Federal) Government Debt/GDP | | | |
| | Below 30% | 30% - 60% | 60% - 90% | 90% and Above |
| Average | 4.3 | 4.1 | 4.2 | 1.0 |
| Median | 4.5 | 4.4 | 4.5 | 2.9 |
| # of Observations | 686 | 450 | 148 | 113 |

As of 1/7/10. Source: "Growth in a Time of Debt" by Carmen M. Reinhart and Kenneth S. Rogoff. NBER Working Paper No. 15639, January 2010.

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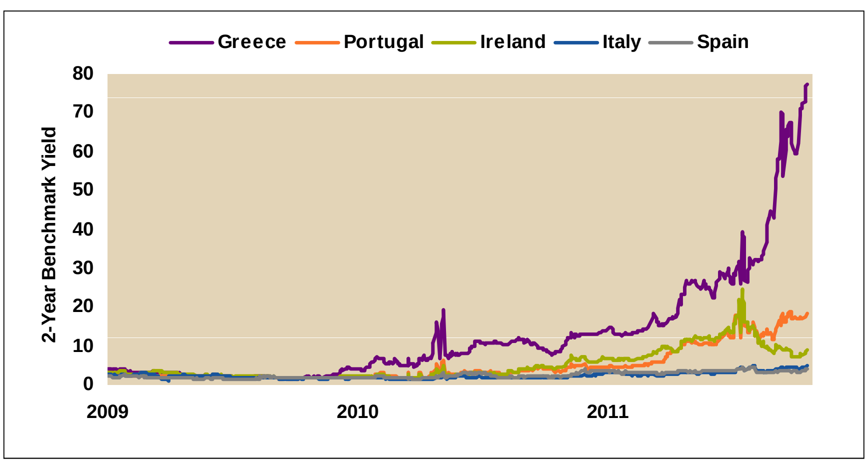
# Eurozone Debt Worries Persist

"Whack-a-Mole" Approach by Eurozone Leaders




As of 10/20/11. PIIGS=Portugal, Ireland, Italy, Greece, Spain. Source: FactSet.

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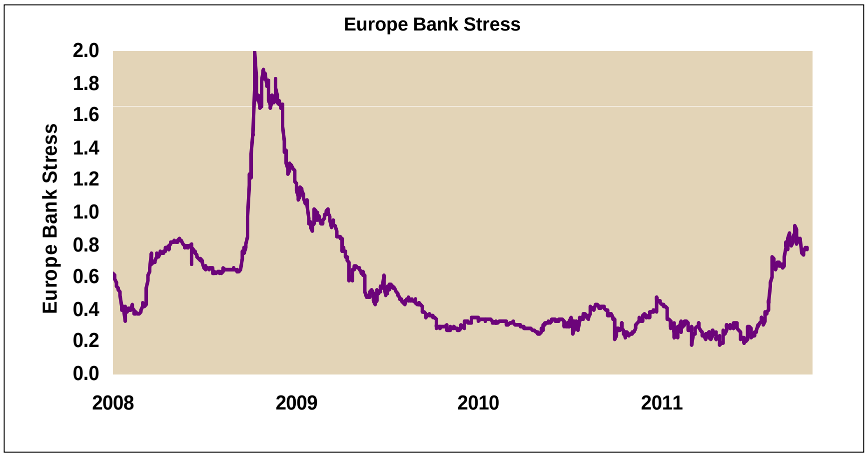
# Eurozone Bank Stress Elevated

But Well Below 2008 Crisis Period




As of 10/20/11. Europe Bank Stress=3-month EURIBOR (Euro Interbank Offered Rate) minus 3-month EONIA (Euro Overnight Index Average) swap rate. Source: FactSet.

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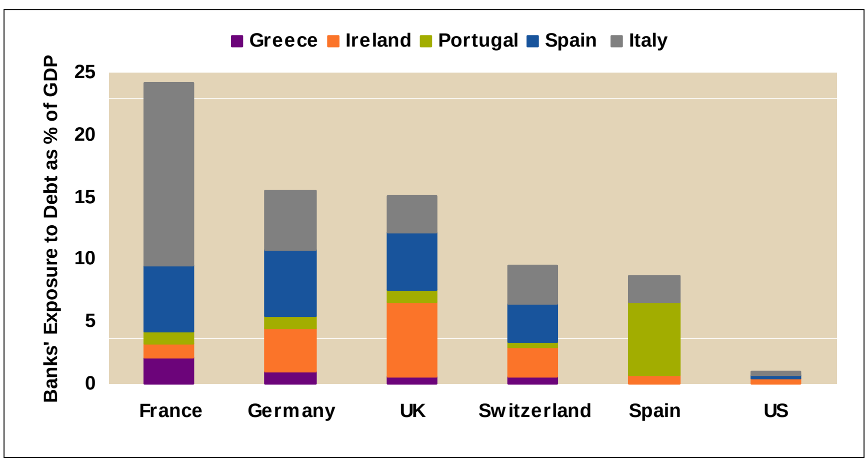
# US Banks' Direct Exposure to Eurozone Limited

But Indirect (e.g., CDS) & Money Market Exposure is Higher




Debt as of 4Q10 and includes public and private. GDP as of 2Q11 and expressed in nominal terms. Source: BCA Research, *Ned Davis Research (NDR), Inc.*
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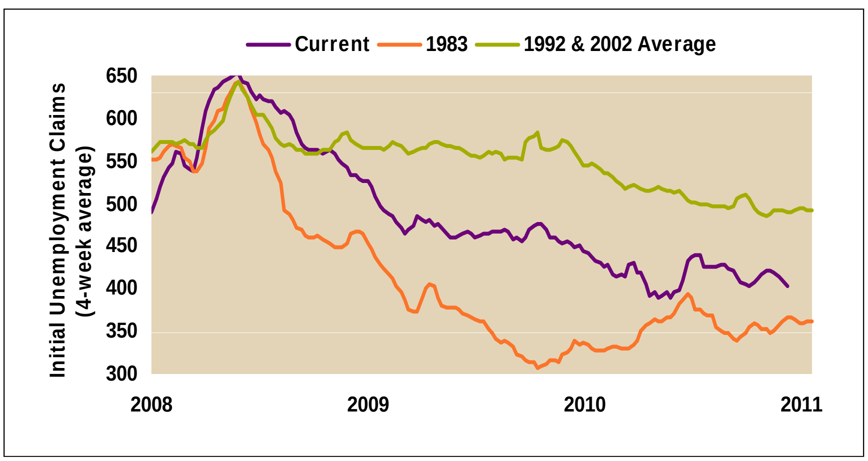
MAXIMUM EMPLOYMENT:
ONE OF FED'S DUAL MANDATES





## Claims Moving Down Again

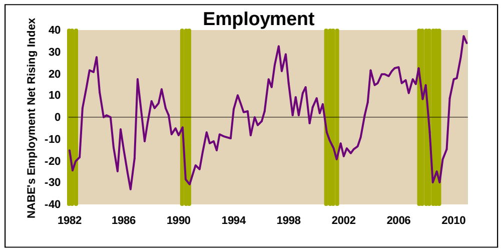
Decisive Move Below 400k is Needed

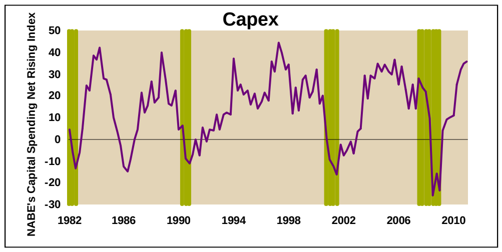



Current (11/7/08-10/14/11). 1983 (5/14/82-5/31/85). 1991 and 2002 (average of 11/2/90-11/26/93 and 5/25/01-6/18/04). Source: Department of Labor, FactSet.

# NABE Survey of Business Suggests Better Jobs/Capex News

But Confidence Crisis is Playing a Role in Limited Hiring




As of 2Q11. The NABE Industry Survey report presents the responses of 74 NABE members to a survey on business conditions in their firm/ industry and reflects 4Q10 results and near-term outlook. Net Rising Index is a diffusion index calculated as the percent of responses reporting rising results minus the percent reporting falling results. Green-shaded areas indicate periods of recession. See last slide for definition of capital spending (capex) and recession. Source: National Association for Business Economics (NABE), National Bureau of Economic Research (NBER).

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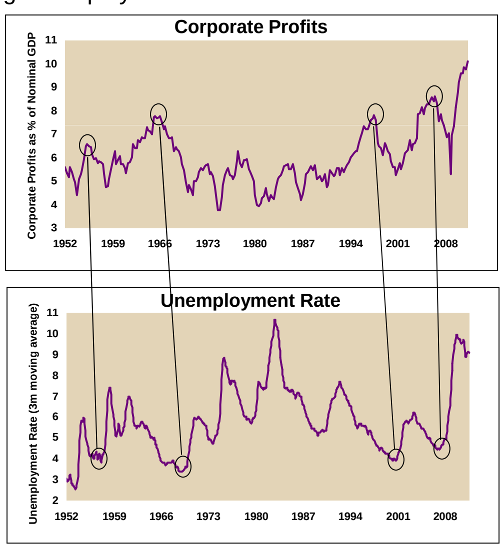
# Corporate Profits on a Tear

Should Be Pulling Unemployment Rate Lower … But it's Not




Corporate profits as of 2Q11 and are after tax with inventory valuation and capital consumption adjustments. Unemployment as 9/11. Source: Bureau of Economic Analysis, Department of Labor, FactSet, ISI Group.

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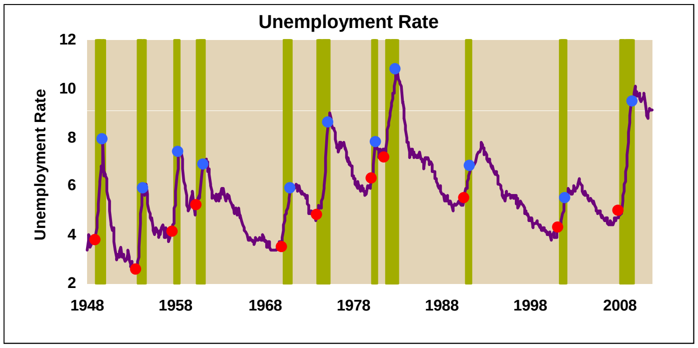
## Unemployment Rate Lags Big Time

Recent Stickiness Troubling But Not Unprecedented




| 4/30/1948-9/30/2011 | |
|---|---|
| Unemployment Rate | S&P 500 Annualized Gain |
| > 6 | 12.8% |
| 4.3-6 | 5.2% |
| < 4.3 | 1.7% |

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As of 9/11. Green-shaded areas indicate periods of recession. Red dots indicate unemployment rate at beginning of recessions and blue dots indicate unemployment rate at end of recessions. See last slide for definition of recession. Source: Bureau of Labor Statistics, FactSet, National Bureau of Economic Research (NBER), *Ned Davis Research, Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.).*

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## PRICE STABILITY:
## ONE OF FED'S DUAL MANDATES

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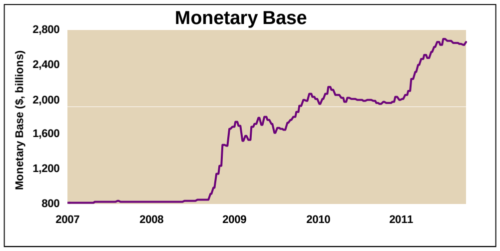
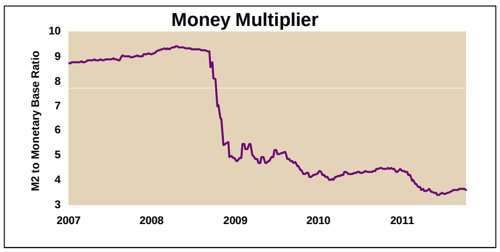
# Fed's Balance Sheet Has Ballooned

But Banks Have Limited Incentive to Lend More Aggressively




Fed flooded system




But "velocity" of money remains depressed

As of 10/11. Source: FactSet, Federal Reserve.

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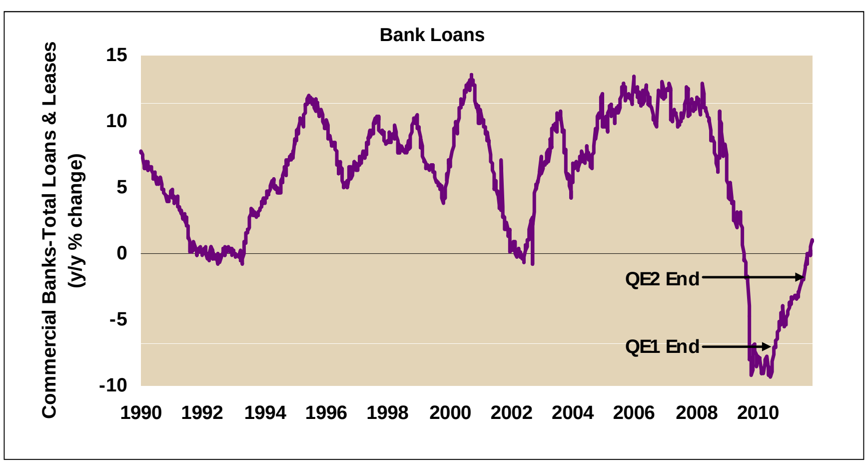
# Bank Loans Now Growing

One of Rationales Behind QE3 Being Off Table For Now




As of 10/7/11. Data prior to 3/31/10 adjusted by Ned Davis Research, Inc. to reflect FAS166 and FAS167 changes. Source: FactSet, *Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.).*

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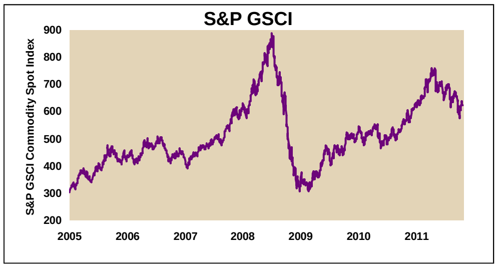
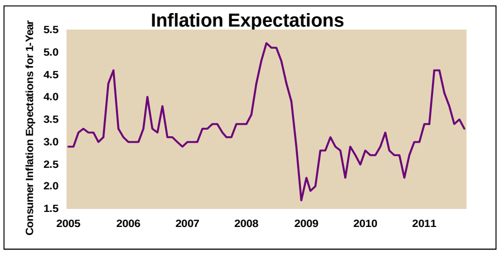
## Commodity Prices Off Peak

Lower Inflation Expectations Will Keep Monetary Policy Easy




S&P GSCI (Goldman Sachs Commodity Index) is as of 10/20/11 and a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The Spot Index represents the change in the price of commodities in the spot market. Consumer Inflation Expectations as of 9/11. Source: FactSet, Standard and Poor's, University of Michigan.

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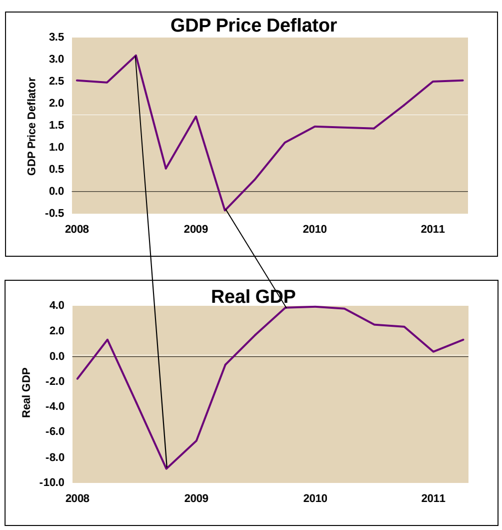
## Rising Inflation Took Bite Out of Real GDP

Falling Commodity Prices Should Help Lift Real GDP




As of 2Q11. GDP based on annualized Q/Q % change. Source: Bureau of Economic Analysis, FactSet, ISI Group.

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STOCK & BOND MARKETS: VALUATION/SENTIMENT

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## Market Suffers Around Recessions

Biggest Hit Came Around Last Recession, Hence Elevated Fear

| Recessions: GDP & Stock Market Performance (1950-2011) | | | | |
|---|---|---|---|---|
| Recession Dates | Peak-to-Trough Real GDP | S&P 500 Peak Date | S&P 500 Trough Date | S&P 500 % Change |
| 7/53-5/54 | -2.6% | 1/5/1953 | 9/14/1953 | -14.8% |
| 8/57-4/58 | -3.7% | 7/15/1957 | 10/22/1957 | -20.7% |
| 4/60-2/61 | -1.6% | 1/5/1960 | 10/25/1960 | -13.4% |
| 12/69-11/70 | -0.6% | 11/29/1968 | 5/26/1970 | -36.1% |
| 11/73-3/75 | -3.2% | 1/11/1973 | 10/3/1974 | -48.2% |
| 1/80-7/80 | -2.2% | 2/13/1980 | 3/27/1980 | -17.1% |
| 7/81-11/82 | -2.9% | 11/28/1980 | 8/12/1982 | -27.1% |
| 7/90-3/91 | -1.4% | 7/16/1990 | 10/11/1990 | -19.9% |
| 3/01-11/01 | -0.3% | 3/24/2000 | 9/21/2001 | -36.8% |
| 12/07-6/09 | -5.1% | 10/9/2007 | 3/9/2009 | -56.8% |
| **Median** | **-2.4%** | | **Median** | **-23.9%** |
| | | 4/29/2011 | 10/3/2011 | -19.4% |

See last slide for definition of recession. Source: FactSet, National Bureau of Economic Research (NBER), www.sentimenTrader.com

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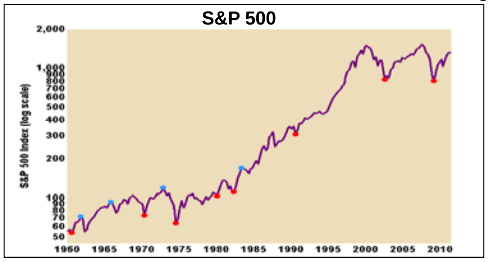
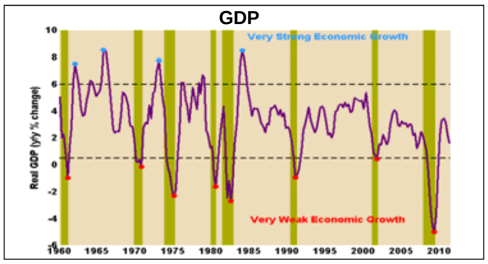
## Stocks Lead the Economy

Market “Likes” Weak-to-Moderate, Not Strong Growth




| 3/31/1960-6/30/2011 | |
|---|---|
| Y/Y % Change of Real GDP | S&P 500 Annualized Gain |
| > 6.0 | -4.6% |
| 0.5-6.0 | 7.2% |
| < 0.5 | 10.5% |

As of 2Q11. Green-shaded areas indicate periods of recession. See last slide for definition of recession. Red dots indicate periods of weak economic growth; blue dots indicate periods of strong economic growth. Circle on table indicates current reading. Source: Bureau of Economic Analysis, FactSet, National Bureau of Economic Research (NBER), *Ned Davis Research, Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.)*, Standard and Poor's.

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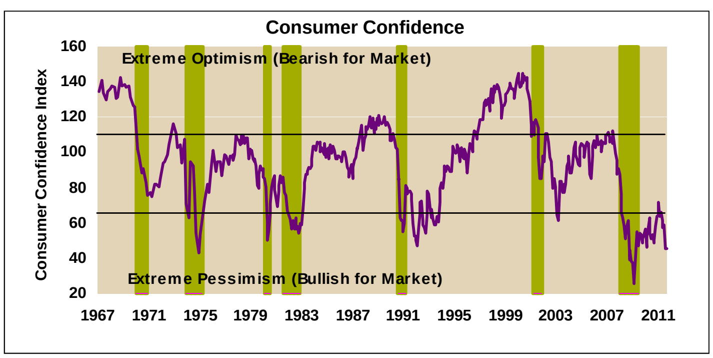
## Consumer Confidence Extremely Pessimistic

But That's Been Good for Market Historically




| 2/28/1969-9/30/2011 | |
|---|---|
| Consumer Confidence | DJIA Annualized Gain |
| > 110 | -0.2% |
| 66-110 | 6.4% |
| < 66 | 12.5% |

We are here

As of 9/11. DJIA=Dow Jones Industrial Average. Green-shaded areas indicate periods of recession. See last slide for definition of recession. Source: The Conference Board, FactSet, National Bureau of Economic Research (NBER), *Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.)*.

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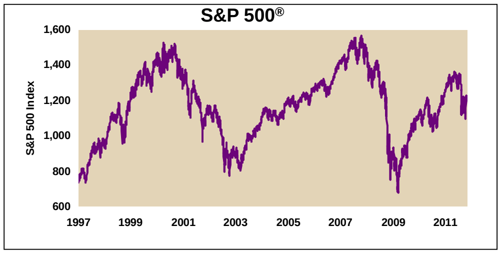
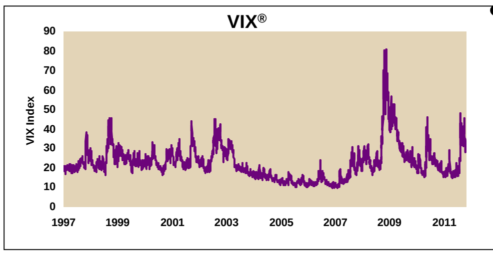
(1011-7018)

# Volatility Spiking Again (Though Below 2008's Levels)

Historically, High Fear Brought Higher Market Returns




| 12/31/1996-10/20/2011 | |
|---|---|
| VIX Index | S&P 500 Annualized Gain |
| > 28.5 | 36.6% |
| 21.5-28.5 | -0.5% |
| < 21.5 | -3.6% |

As of 10/20/11. Source: Chicago Board Options Exchange (CBOE), FactSet, *Ned Davis Research, Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.)*, Standard and Poor's.

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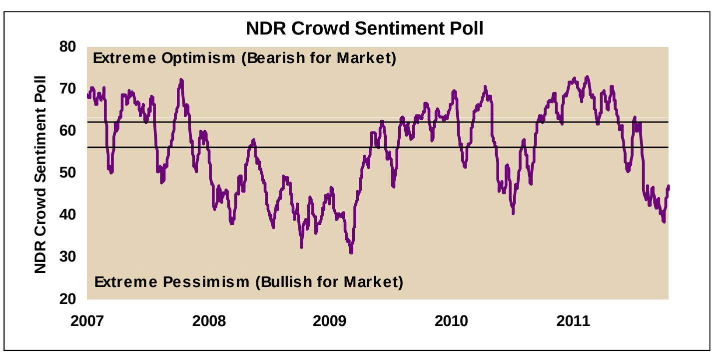
# Investor Confidence Got Crushed by Market's Rout

"Wall of Worry" Remains




| 12/1/1995-10/18/2011 | |
|---|---|
| NDR Crowd Sentiment Poll | S&P 500 Annualized Gain |
| > 62 | -0.2% |
| 56-62 | 4.4% |
| < 56 | 9.0% |

We are here

As of 10/11/11. See last slide for description of Crowd Sentiment Poll. Source: Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission. Copyright 2011 (c) Ned Davis Research, Inc. All rights reserved.).

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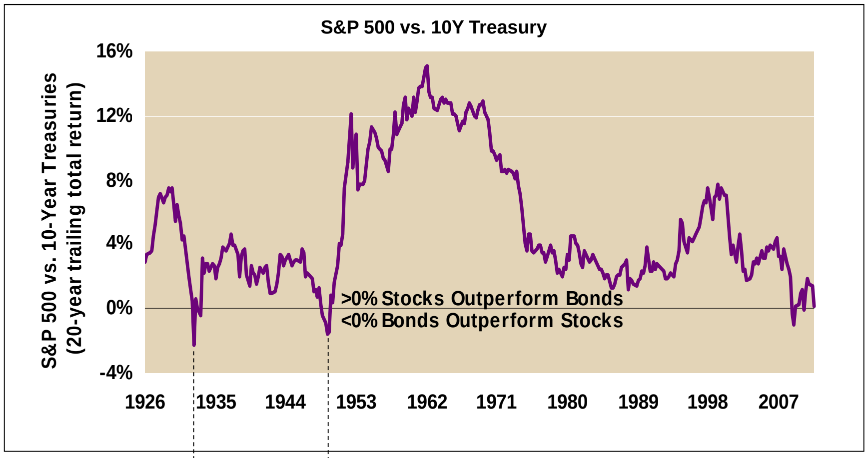
## Longer-Term, Reversion to Mean for Stocks/Bonds?

Hovering Around Rare 20-Year Outperformance by Bonds




**Five Years Later**
**S&P 500 TR: +33.8% (ACR)**
**10-Year Treasury TR: +4.6% (ACR)**

**Five Years Later**
**S&P 500 TR: +23.1% (ACR)**
**10-Year Treasury TR: +1.6% (ACR)**

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As of 3Q11. TR=total return. ACR=annual compound rate of return. Source: The Leuthold Group.

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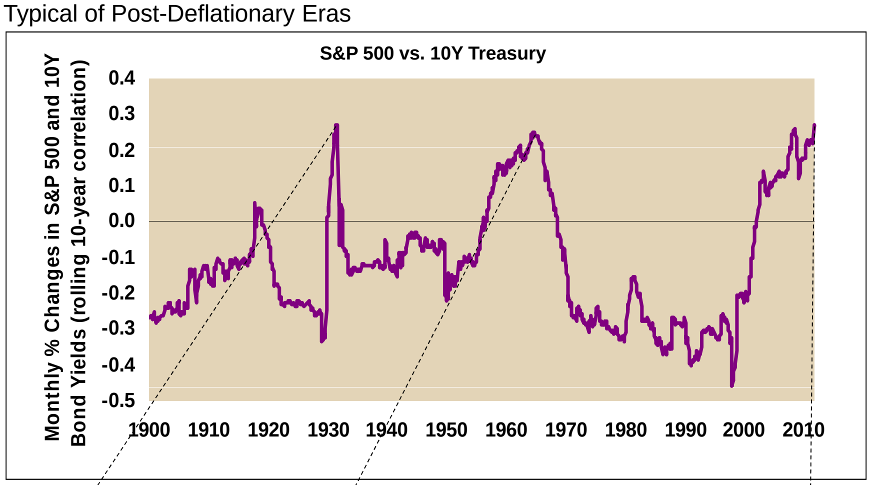
## Bond Yields & Stock Prices Positively Correlated

Typical of Post-Deflationary Eras




**Correlation surged at onset of deflationary 1930s**

**Correlation moved up in 1950s after post-WWII inflation finally broken**

**Excess supply from emerging markets over last decade & 2008 crisis brings on deflation**

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As of 9/11. Source: FactSet, The Leuthold Group.

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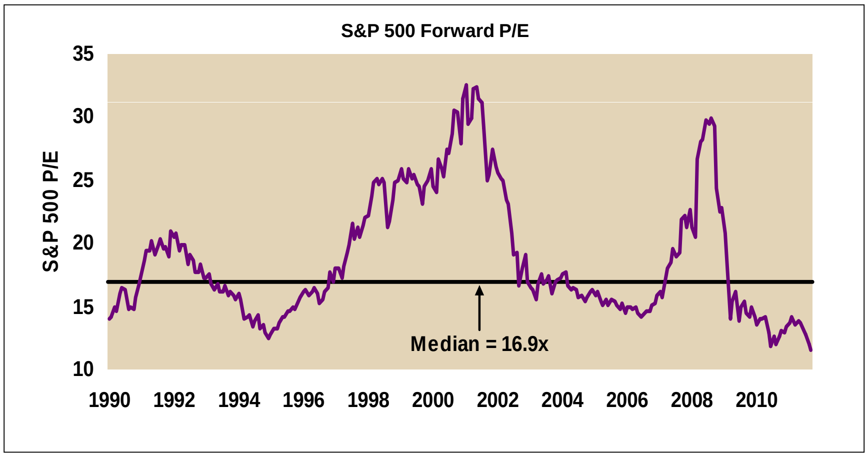
## On Forward Earnings, Stocks Are Very Cheap

Driver Passing From Margins/Cost-Cutting to Top-Line Growth




**Current Forward P/E @ 11.8**

As of 9/11. Current P/E based on estimated 3Q11 EPS. P/Es are based on forward 12-month operating earnings. Source: FactSet, Standard & Poor's.

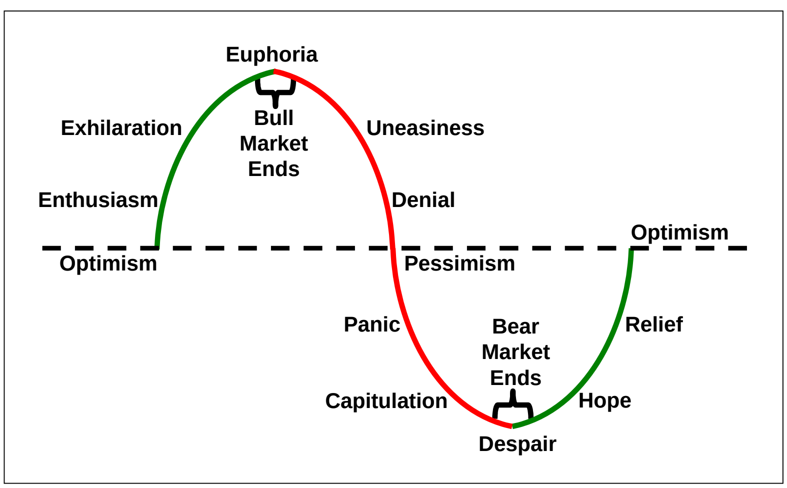






## Market's Emotional Roller Coaster

Maintaining Discipline = Key to Long-Term Success



# Disclosures/Definitions

**Disclosures**

The information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

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Examples provided are for illustrative purposes only and not intended to be reflective of results you should expect to attain.

**Definitions**

Indexes are unmanaged, do not incur management fees, costs and expenses (or "transaction fees or other related expenses"), and cannot be invested in directly.

***The Dow Jones Industrial Average*** (DJIA, "The Dow") is a price-weighted average of 30 actively traded blue chip stocks, primarily industrials and is the oldest and most widely quoted of all the market indicators.

***The S&P 500 Index*** is a capitalization-weighted index of 500 stocks from a broad range of industries. The component stocks are weighted according to the total market value of their outstanding shares.

**Terms:**

***Asset Allocation*** - The strategy of spreading your investment funds across categories of assets such as stocks, bonds and cash investments to help offset risks and rewards, based on your goals, time horizon and risk tolerance.

***Capital Spending (Capex)*** - Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations.

***Ned Davis Research (NDR) Crowd Sentiment Poll*** - Shows perspective on a composite sentiment indicator designed to highlight short- to intermediate-term swings in investor psychology. It's based on seven different individual sentiment indicators in order to represent the psychology of a broad array of investors.

***Recession*** - As per National Bureau of Economic Research (NBER), a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

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