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2015 Q3 Capital Markets Review

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Q3 Capital Markets Review

The third quarter of 2015 was characterized by several straws that broke the camel's back. We expected economic conditions to materially improve in the third quarter; when they did not, and other global economic indicators in fact worsened, an environment for correction was created. Ultimately, the S&P 500 index corrected over 12% from its mid-July levels before stabilizing at more reasonable valuation levels.

All year long, the absence of a clear catalyst had restrained markets on both the upside and the downside. Heading into Q3, a significant amount of uncertainty created volatility in the markets. The Federal Reserve was expected to raise interest rates amid an uncertain economic backdrop, but one which was expected to improve as first-quarter headwinds faded. Adding to the confusion were Syrian refugees pouring into Europe and Russia's ongoing power play in the Middle East.

The expected improvement in economic conditions ultimately failed to materialize. Europe treaded water, the US economy did not expand as expected, and credit conditions in emerging markets began to worsen. The deterioration in the Chinese economy presented a significant fundamental economic concern, adding fuel to the fire. The Federal Reserve refused to raise interest rates, citing global economic concerns. Equity market multiples, already stretched on the basis of an improving third-quarter economic environment, ultimately contracted.

There is precedent for such a situation, the key to which is a notable lack of systemic risk. Non-recessionary corrections of 10-15% are generally healthy for markets, as evidenced in 1998 and 2011. The Fed's decision to keep rates at zero adds a further silver lining, along with low interest rates, liquid credit markets, stable credit default swap indices, and somewhat stable treasury yields and treasury yield spreads. Ultimately, improvement in the equity markets must be backed by economic strength, but in the absence of systemic economic weakness, there is precedent for a stabilization and ultimate expansion of the equity multiple.

The following indicators are representative of the overall economic climate in the third quarter of 2015.

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July:

- Domestic data in July, which improved in June and showed promise heading into the latter half of the year, was unexpectedly mixed. Abroad, China in particular weakened as the rate of growth in parts of the manufacturing sector declined to the slowest since May, 2014.

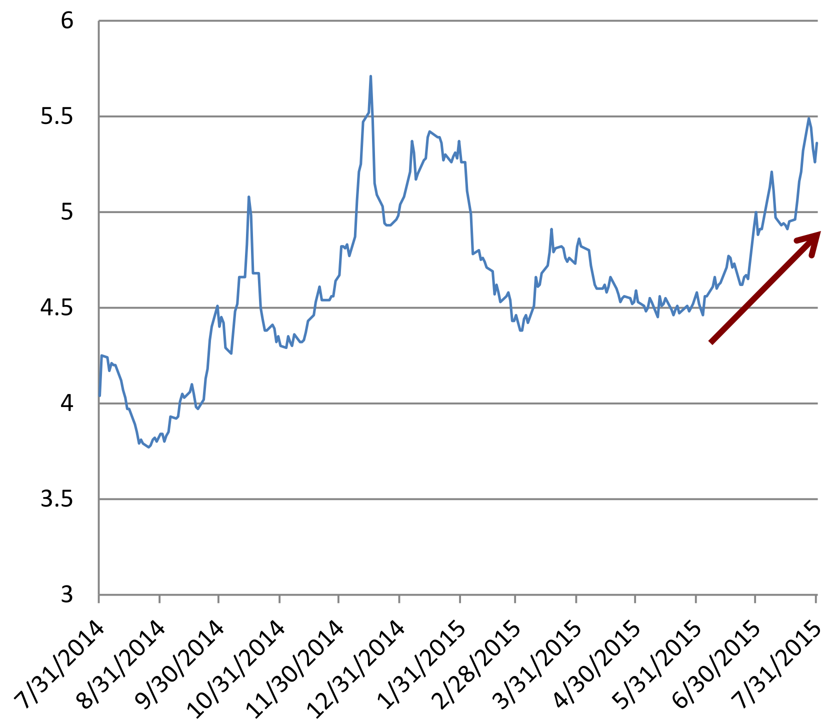
- Stocks continued to display angst in the month of July, as mixed data and earnings translated into equity market volatility. Adding fuel to the fire was the anticipation of a Fed rate hike in September, which ultimately did not materialize.

Q3 Capital Markets Review July

- Credit spreads from emerging markets to US high yield markets began to increase. This results from higher relative yields at the long end of the yield curve, which implies increased risk.

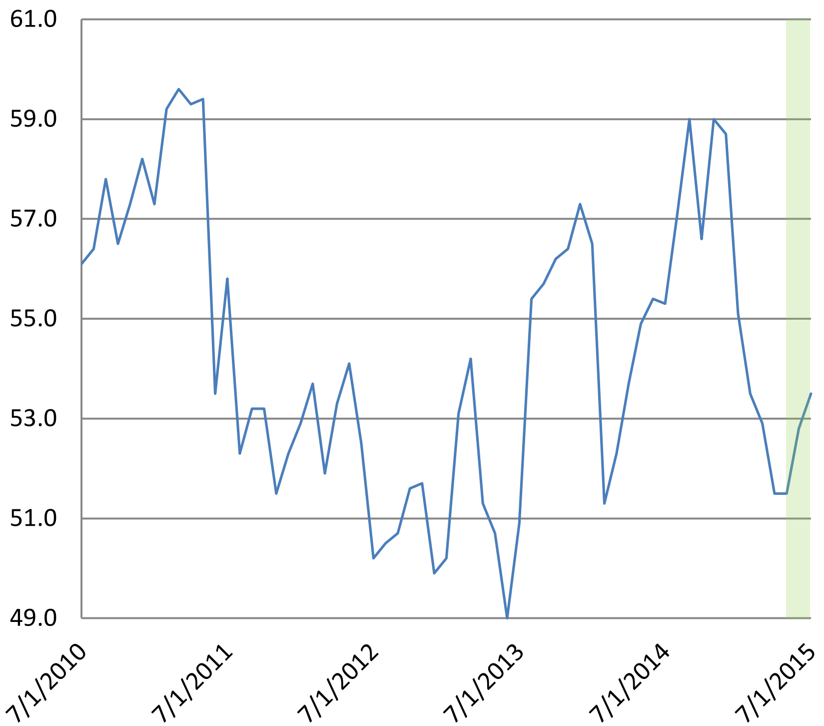
Emerging Markets Credit Spread, July 2014 – July 2015

US High Yield Credit Spread, July 2014 – July 2015

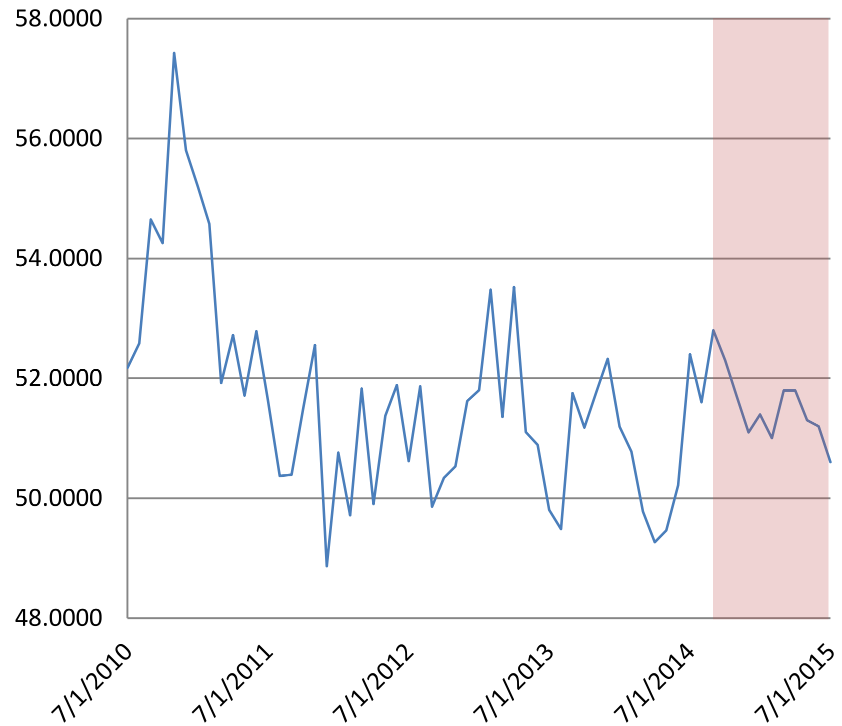


- US manufacturing improved for the second straight month in July, setting the stage for a 2H2015 economic expansion that ultimately failed to materialize. Economic conditions in China, meanwhile, continued to deteriorate.

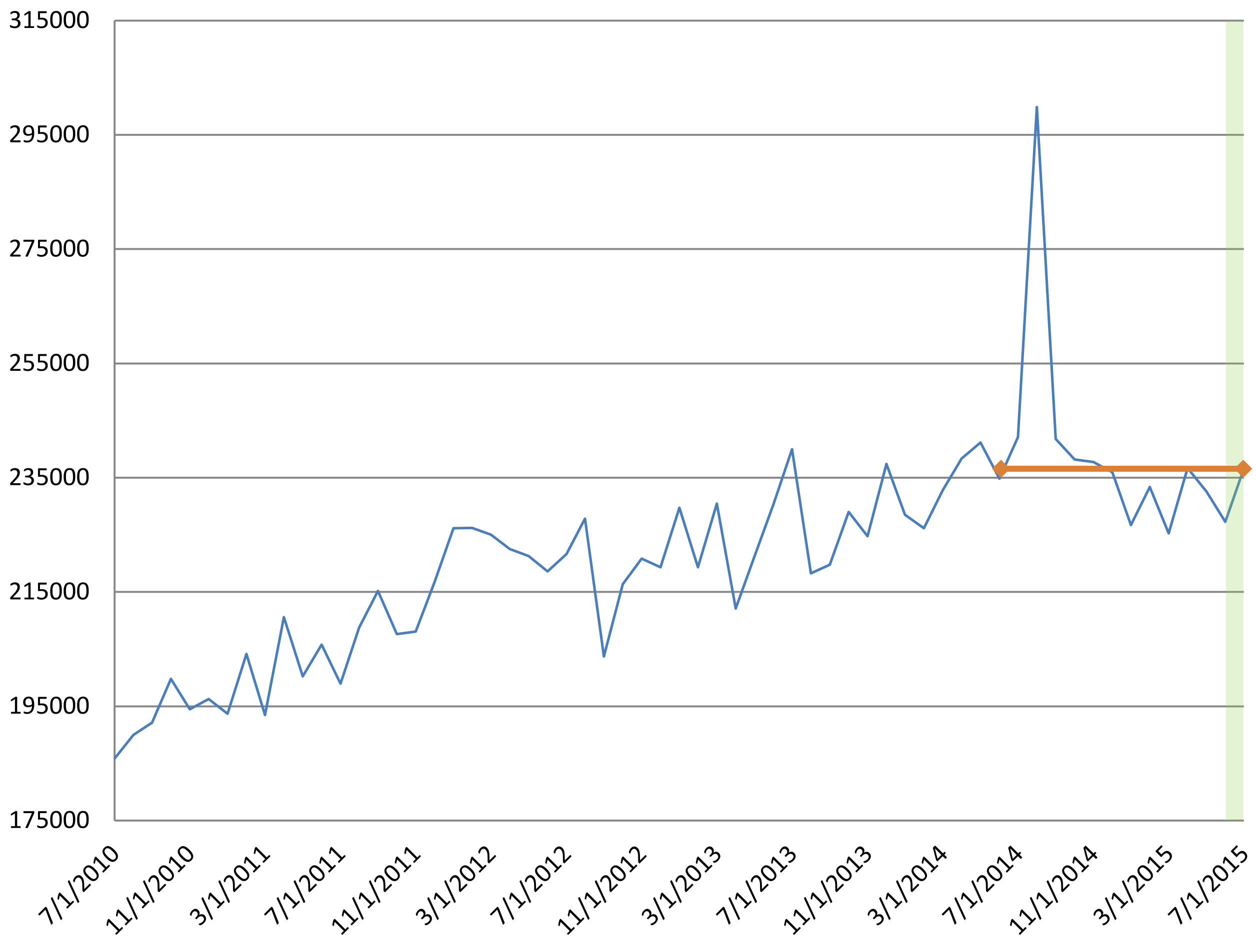
ISM Manufacturing Index, July 2010 – July 2015



China Composite PMI Survey, July 2010 – July 2015



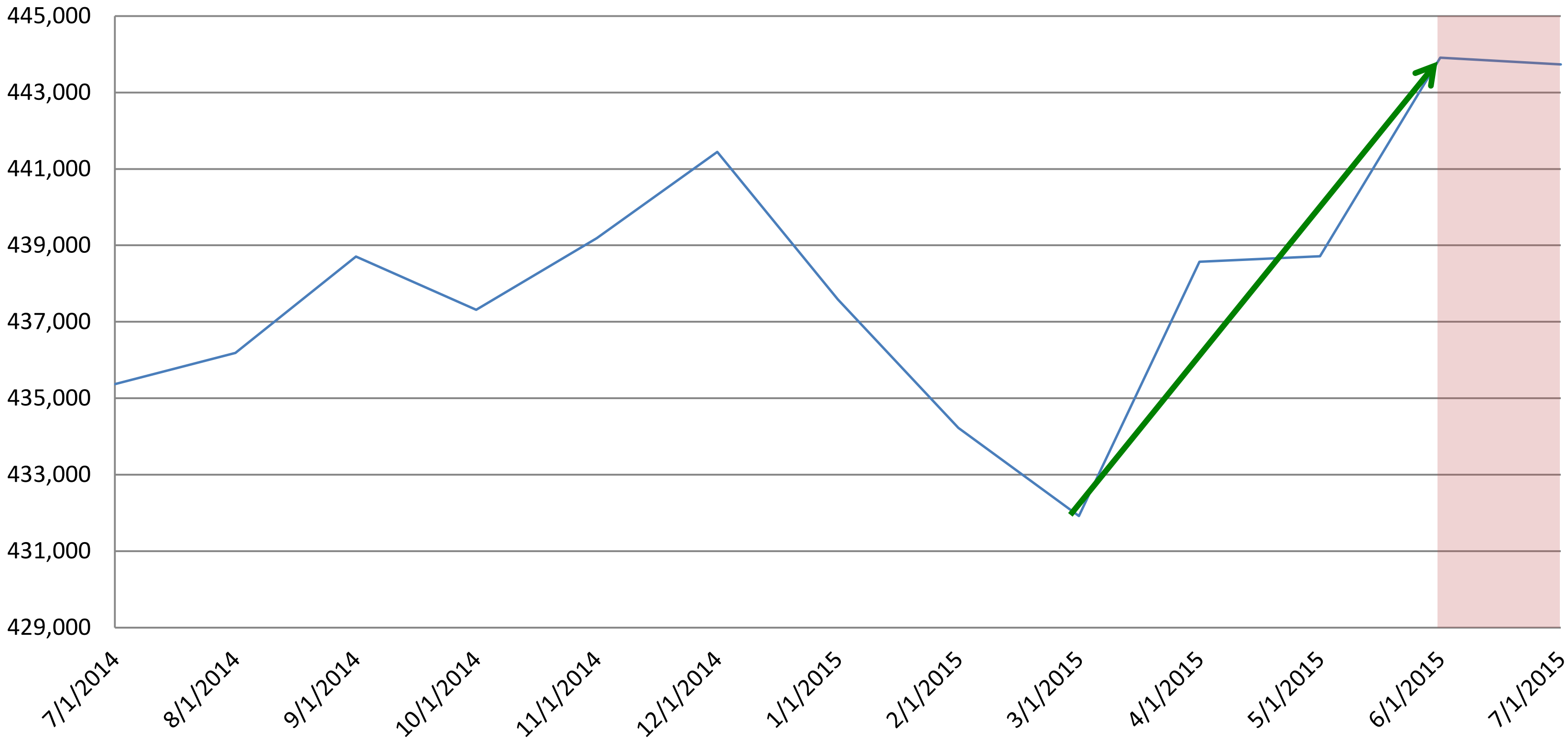
US Durable Goods Orders, July 2010 – July 2015



- US durable goods orders improved mildly in July but failed to expand year-over-year.
- Although the stability in durable goods was not inherently negative, flat durable goods orders year to date implied a lack of growth in aspects of the US economy.

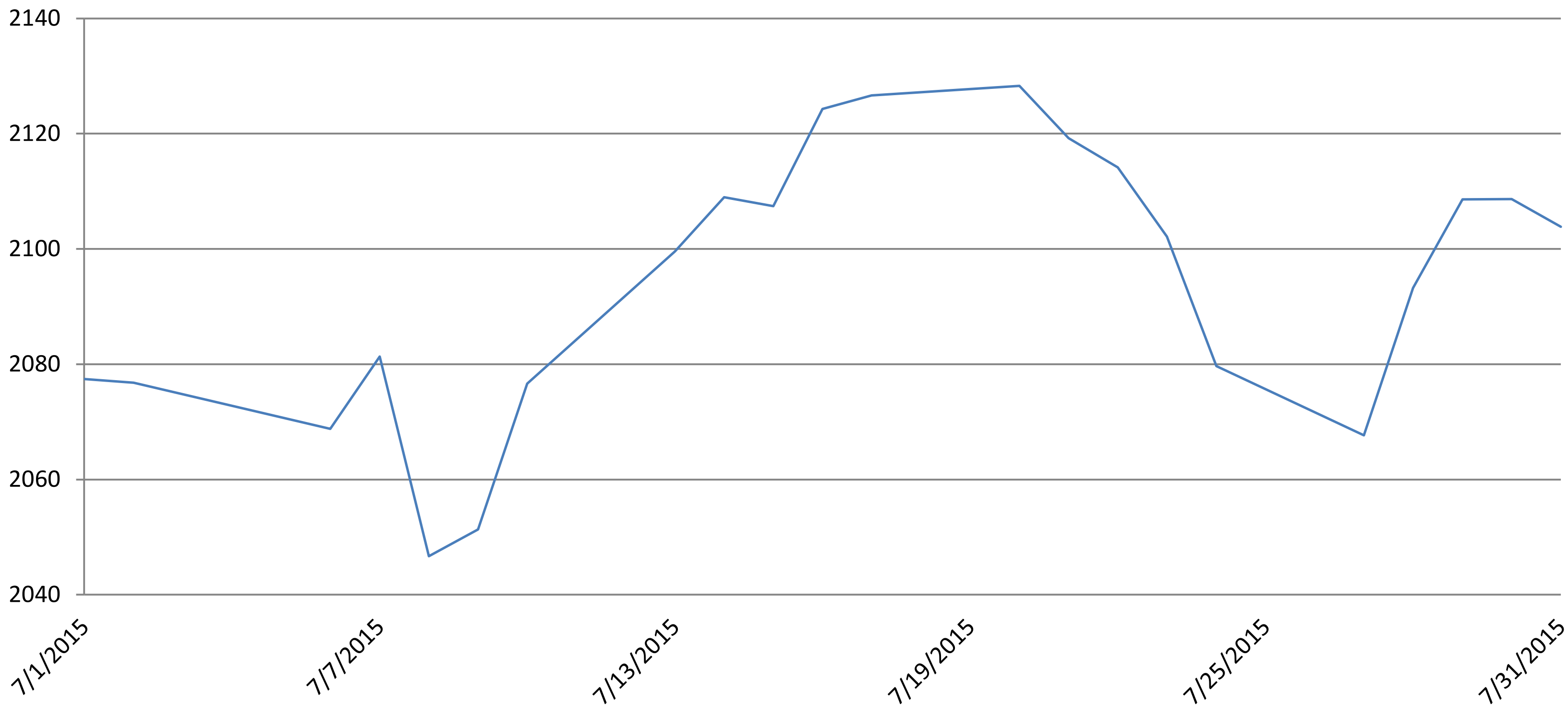
- The nominally declining July retail sales figure implied that aspects of the US economy may not have been growing as expected. It is worth noting that such a nominal decline following several months of gains may not necessarily indicate weakness.

US Retail Sales, July 2014 – July 2015



Q3 Capital Markets Review July

S&P 500 Index, July 2015



- Equity markets in July were volatile, mirroring mixed economic data and uncertain fundamental global economic conditions.

August:

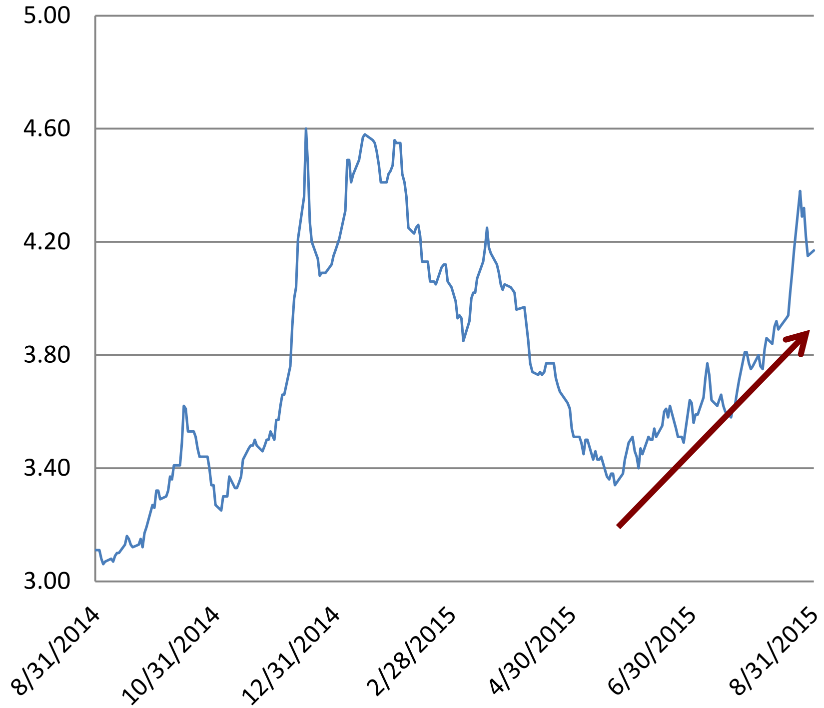
- Domestic data in August remained mixed as the US economy in general, and manufacturing in particular, struggled to break out. Global economic data worsened with China and emerging markets worsening notably and commodities declining sharply. Credit markets also worsened in August with spreads widening and US Treasury yields falling to their lowest level in several months.

- Importantly, none of these developments presented systemic risk that would threaten the long-term integrity of the markets. The US economy did not appear to be near recession, and a secular bear market seemed unlikely.

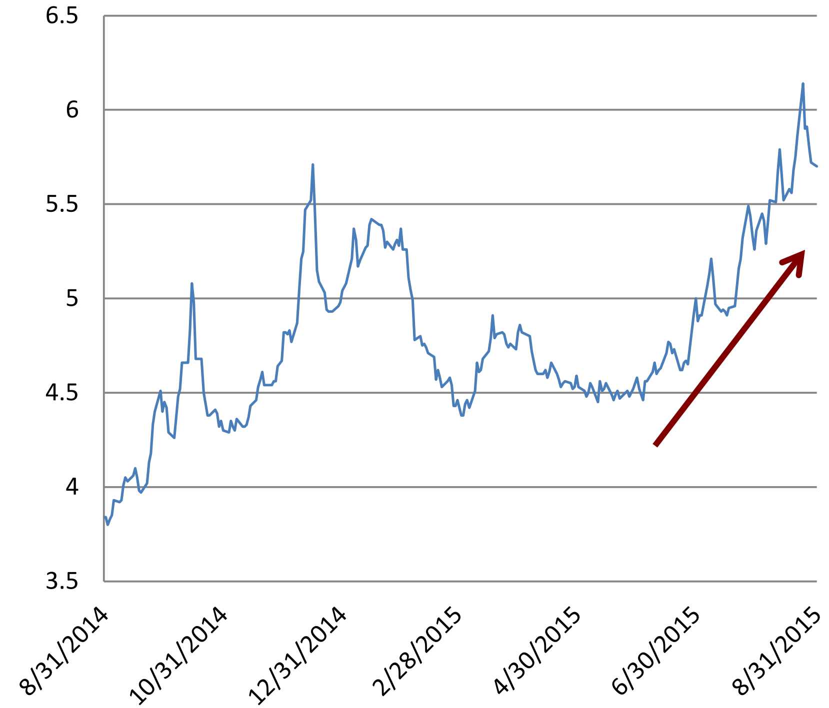
Q3 Capital Markets Review — August

- Credit market spreads continued to widen in August, indicating increasingly elevated risk across corporate credit instruments and markets.

Emerging Markets Credit Spread, August 2014 – August 2015



US High Yield Credit Spread, August 2014 – August 2015



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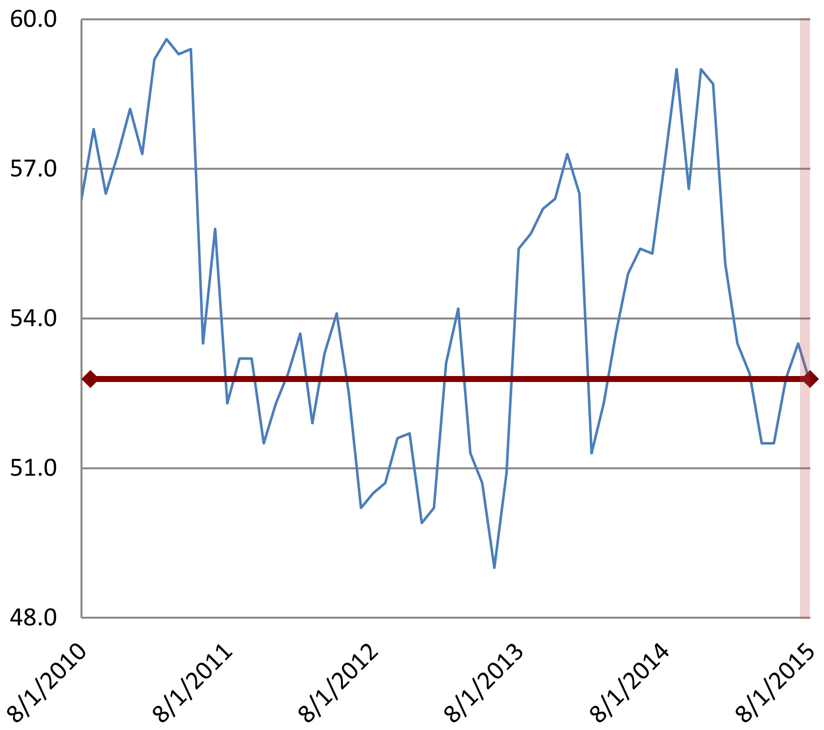
- The CBOE put/call ratio broke out of its range in early August and climbed precipitously throughout the month. This indicated bearish underlying options activity incongruent with equity market activity until mid-August, at which point equity markets corrected to come back into line with derivatives markets.

CBOE Equity Put/Call Ratio (Smoothed), August 2014 – August 2015

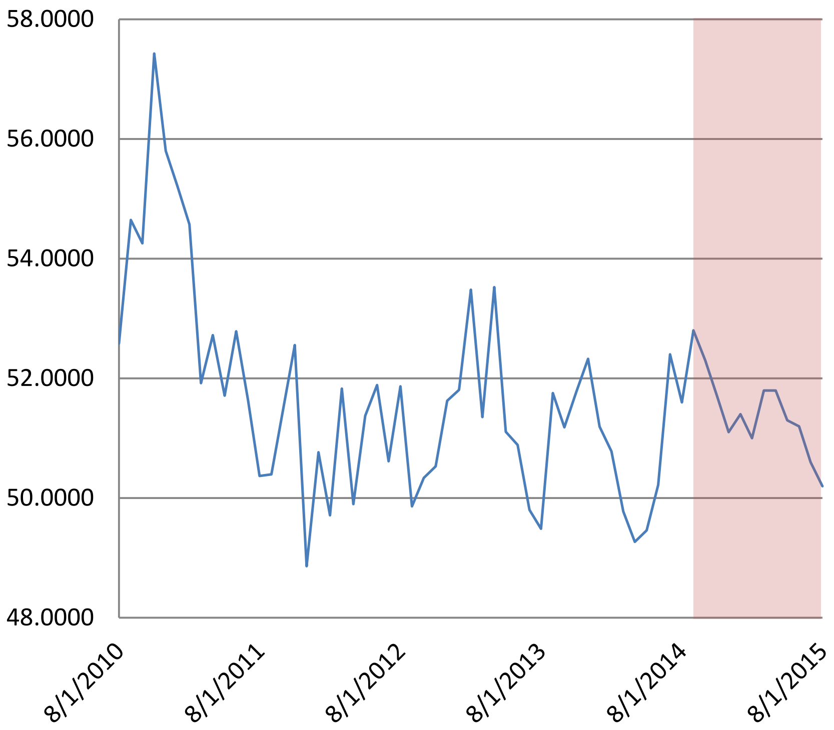
Q3 Capital Markets Review August

- After brief upticks in June and July, US manufacturing deflated somewhat in August, settling at barely expansionary levels. China continued to deteriorate, and Europe (not pictured) was mixed.

ISM Manufacturing Index, August 2010 – August 2015



China Composite PMI Survey, August 2010 – August 2015



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iShares S&P GSCI Commodity-Indexed Trust, August 2014 – August 2015

- After several months of recovery, commodity prices began declining again in July and hit multi-year low levels in August.

- Commodity prices bounced in the last week of August, driven by an uptick in oil prices.

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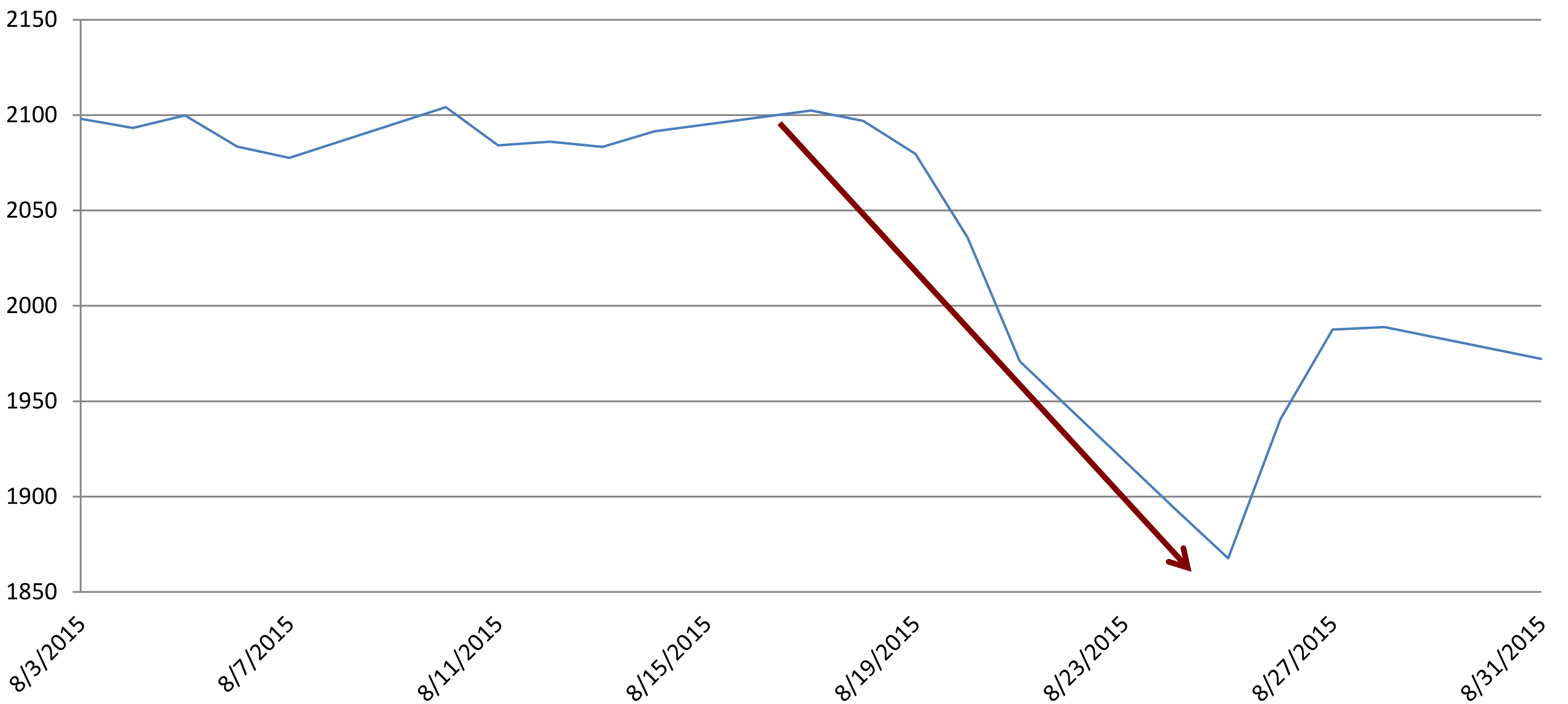
- The S&P 500 index corrected over 10% in August, the largest correction since the summer of 2011. Such corrections often act as a valuation adjustments for equities in line with a recent weakening of the global macro environment.

S&P 500 Index, August 2015



September:

- Global economic conditions in August were steady in September with data failing to improve but not materially worsening either. Importantly, there was a notable lack of “new bad news” as markets consolidated and formed a technical resistance to the downside.

- It became apparent to us that our August assessment of the correction as a valuation adjustment as opposed to a sign of worse things to come was the case, with systemic risk absent from the equation and recession essentially off the table in the near term.

- The S&P 500 index formed a double technical resistance in September, bouncing off resistance levels with conviction and forming a technical foundation for near-term gains.

S&P 500 Index Candlesticks, September 2014 – September 2015

Source: Yahoo! Finance

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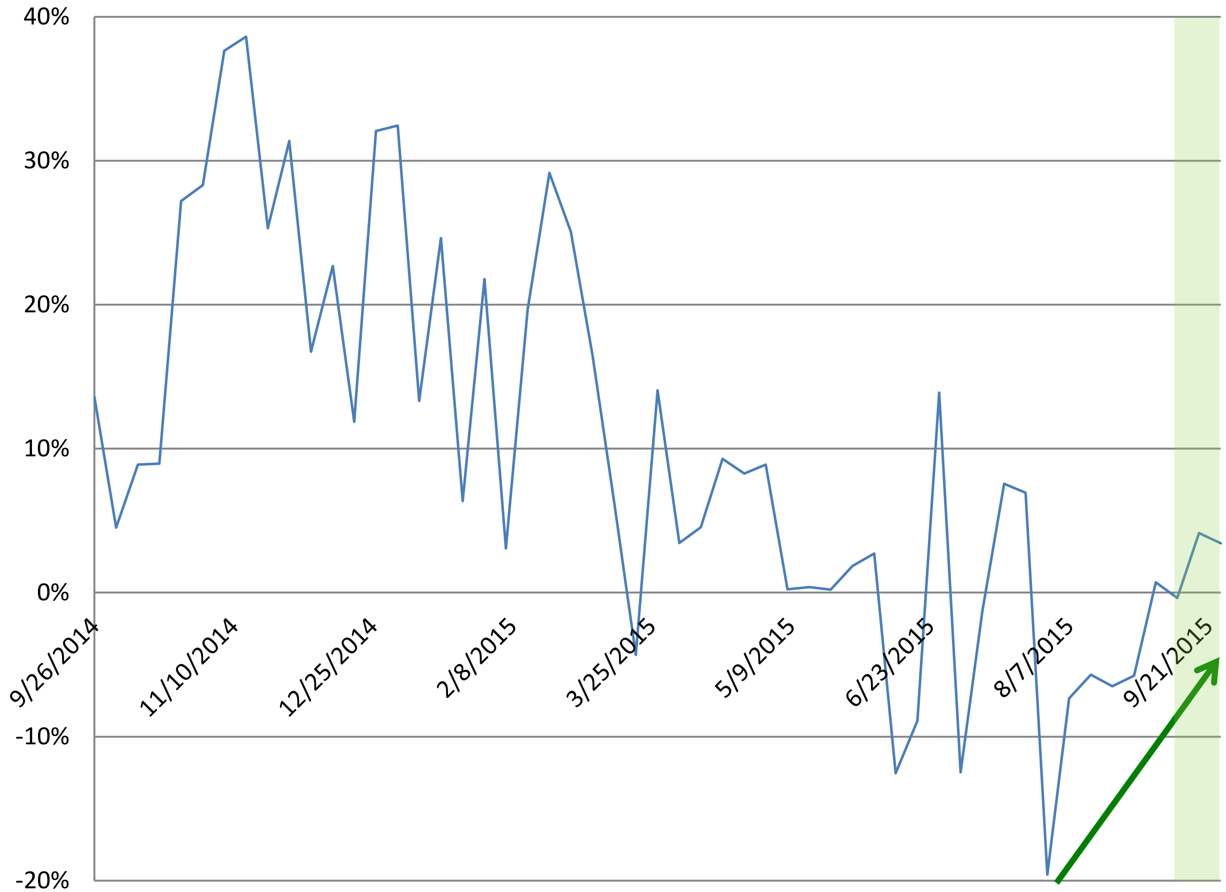
- Investor sentiment climbed in September, breaking above zero and indicating net bullishness by the first week of September.

- Moderate but gradually climbing investor sentiment indicates market recovery.

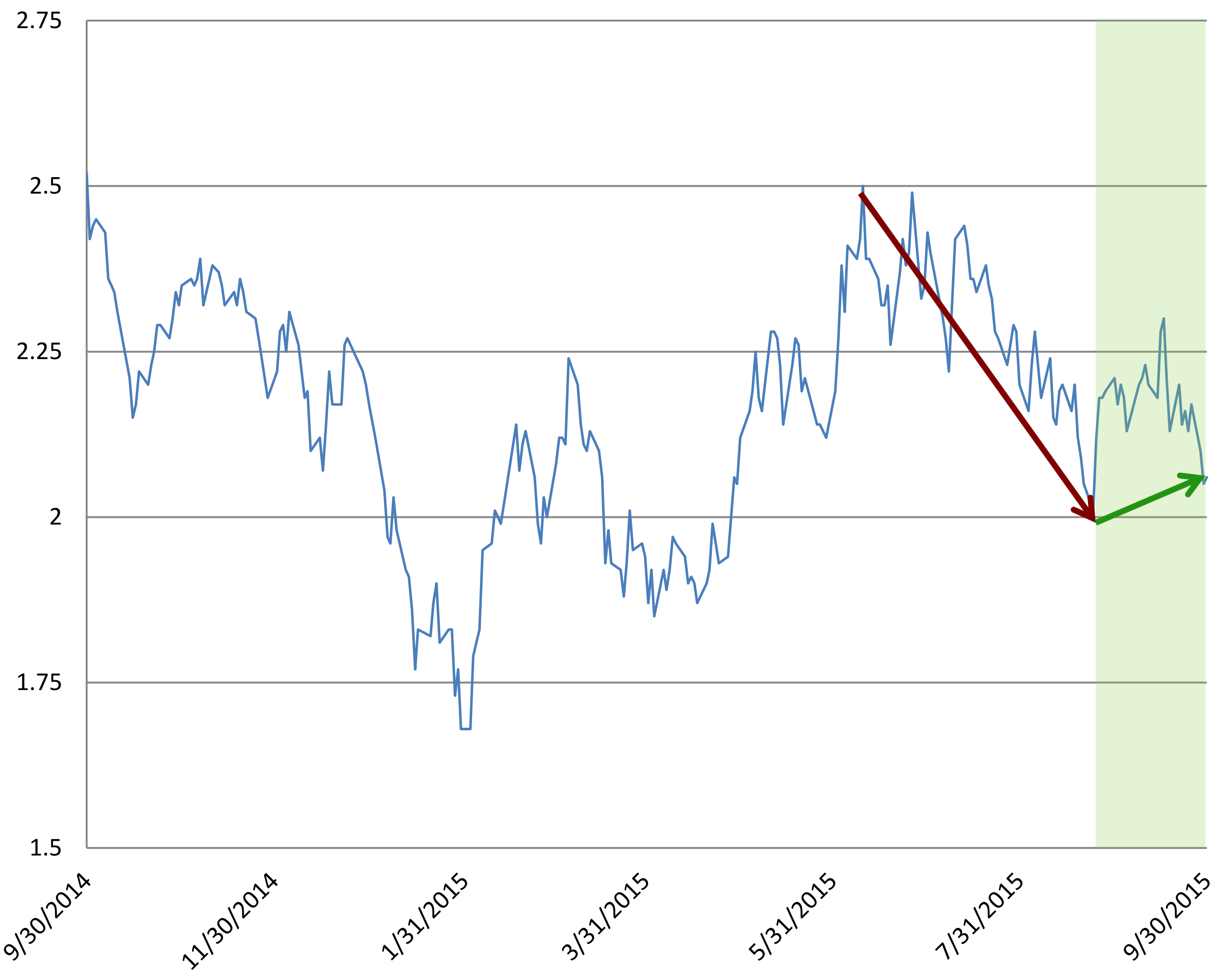
AAII* Investor Sentiment Index (Net), September 2014 – September 2015



**American Association of Individual Investors*

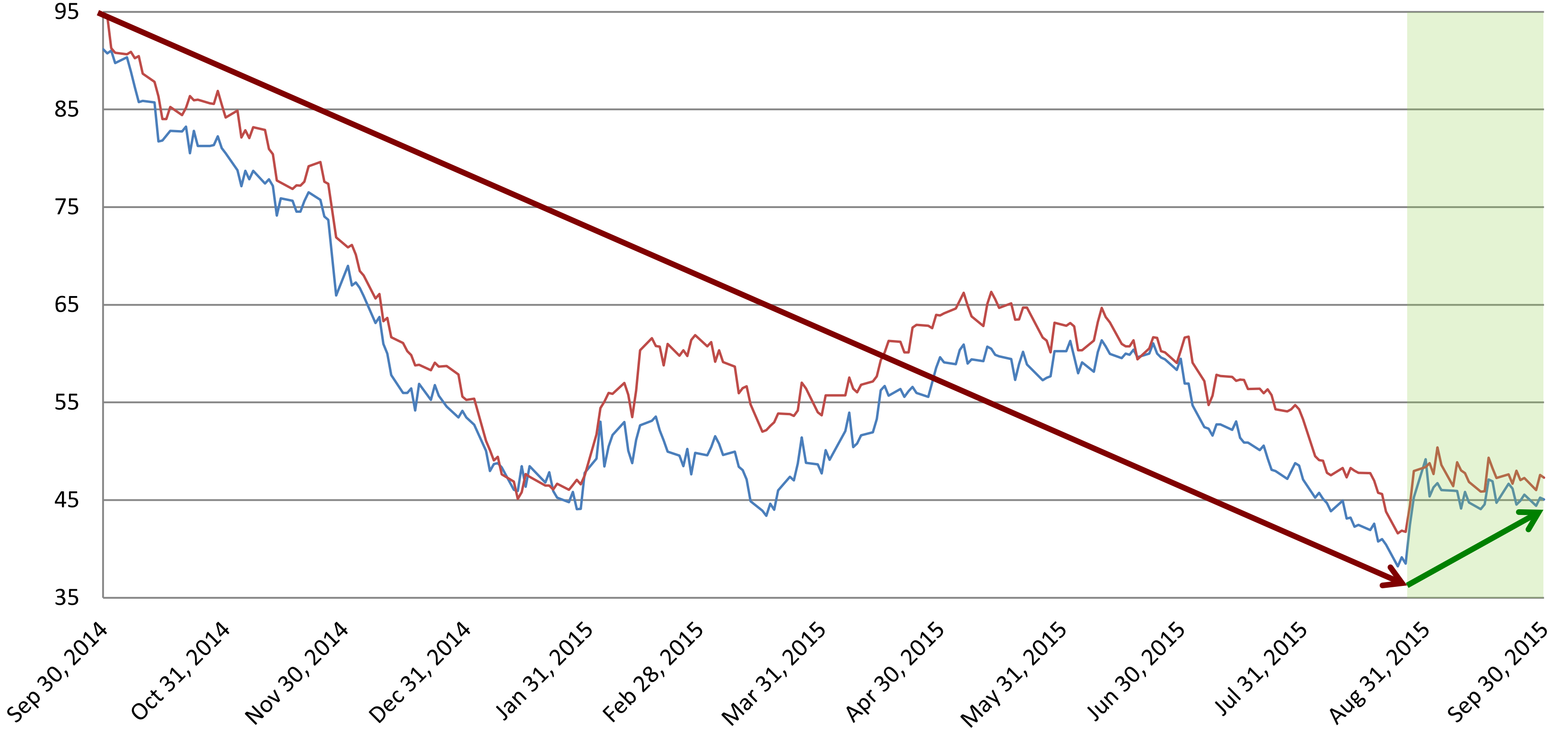
US 10-Year Treasury Bond Yield, September 2014 – September 2015

- After dropping in July and August in anticipation of the Fed raising rates, Treasury yields stabilized somewhat in September.
- Higher Treasury yields generally indicate money flowing out of Treasuries and into equities, anticipation of rising interest rates, or a combination of both.



- Crude oil prices stabilized in September. Though this was largely due to supply concerns stemming from geopolitical issues in the Middle East, it was nonetheless encouraging to see stabilization in commodity prices following over a year of declines.

Price of Crude Oil, September 2014 – September 2015



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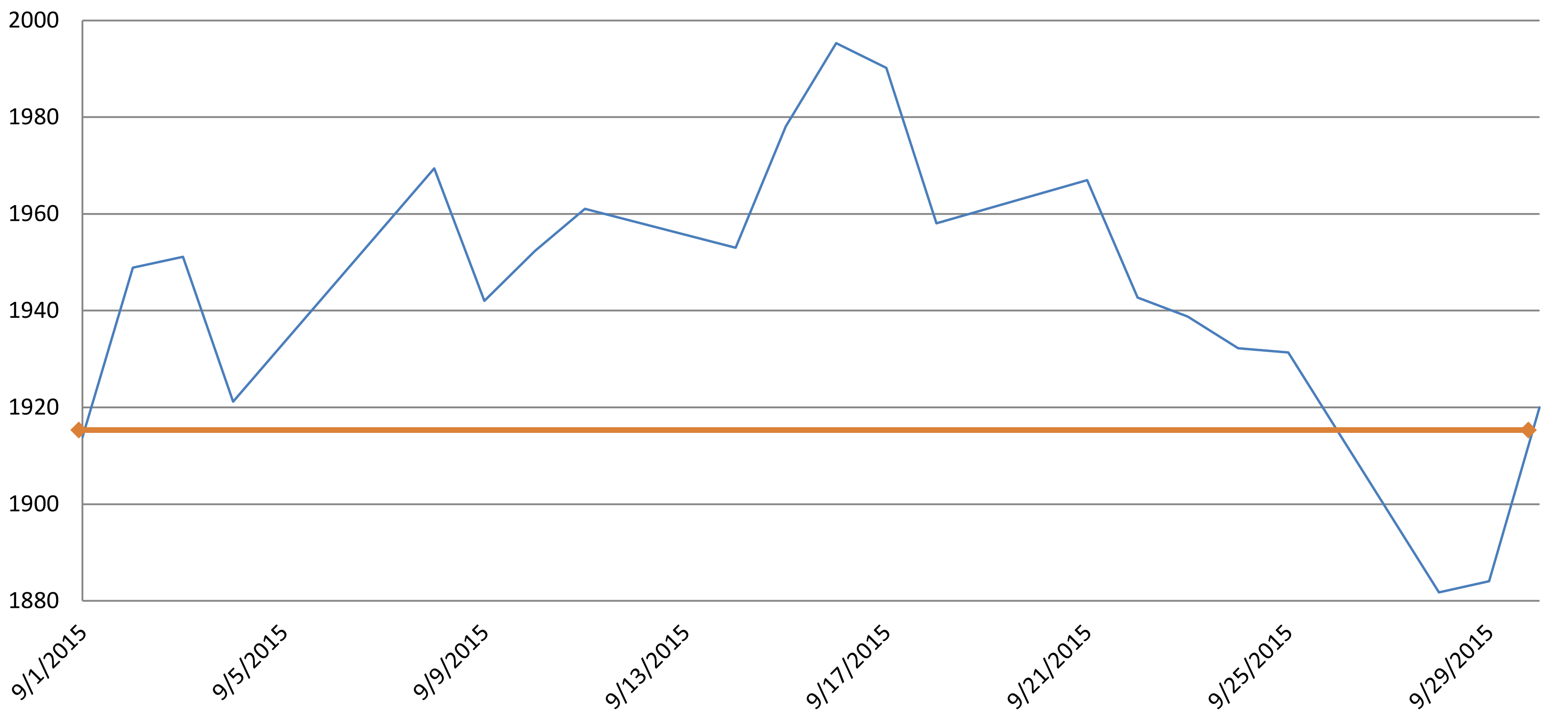
Q3 Capital Markets Review — September

- September was the hangover to August's wild ride, with volatility lingering and financial markets finding a footing. Concerns over global weakness did not fade, but in the absence of a fresh batch of bad news, further declines were limited.

S&P 500 Index, September 2015



Global Economic Indicator Descriptions

The ISM Manufacturing Index is a survey-based measure of manufacturing conditions in the United States.

The China Manufacturing PMI Survey is a survey-based measure of manufacturing conditions in China.

The S&P 500 is a value-weighted index of 500 widely held common stocks, whose performance reflects changes in stock market conditions.

The US Retail Sales MoM Change report is an index measuring the monthly change in adjusted US retail and food service sales.

The US Durable Goods Orders is a measure of the demand for durable goods manufactured in the US.

The US 10-Year Treasury Bond Yield is the interest rate on the bond issued by the United States government that matures in 10 years.

The Price of Brent Crude Oil is a benchmark that measures global crude oil prices.

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Global Economic Indicator Descriptions

The iShares S&P GSCI Commodity-Indexed Trust is a measure of commodity prices as measures by the S&P GSCI Commodity Index.

The Emerging Markets Credit Spread is the difference between the short and long ends of the yield curve for corporate debt securities issued in emerging markets.

The US High Yield Credit Spread is the difference between the short and long ends of the yield curve for high-yield corporate debt securities issued in the United States.

The Price of WTI Crude Oil is a benchmark that measures US crude oil prices.

The AAII Investor Sentiment Index measures the percentage of individual investors who are bullish, bearish, and neutral on the stock market for the next six months.

The CBOE Equity Put/Call Ratio is the ratio of puts to calls traded on the CBOE Options Exchange. It includes equity options only.

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Disclosure

L&S Advisors, Inc. is a privately owned corporation headquartered in Los Angeles, CA. L&S Advisors was originally founded in 1979 and dissolved in 1996. The two founders, Sy Lippman and Ralph R. Scott, continued managing portfolios together and reformed the corporation in May 2006. The firm registered as an investment adviser with the U.S. Securities and Exchange Commission in June 2006. L&S Advisors performance results prior to the reformation of the firm were achieved by the portfolio managers at a prior entity and have been linked to the performance history of L&S Advisors. These results should not be interpreted as the actual historical performance of L&S Advisors.

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All data for global economic indicators has been provided by Thompson Reuters. Data for the S&P 500 index has been provided by the Federal Reserve Bank of St. Louis.

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