Q1 2016 Capital Markets Review

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Q1 Capital Markets Review

The December malaise awakened explosively to start 2016. The market correction that had been held back by managers' push for returns in December let loose in January as the S&P 500 index corrected over 10% to start the year. Fluctuations were extreme as algorithmic trading had an outsized effect on volatility. Ultimately, however, the overly aggressive correction and a modicum of fundamental economic improvement stabilized markets, with the S&P closing the first quarter essentially flat (+77 bp).

Economic conditions continued to deteriorate at the start of the year. Contracting YoY earnings, weak US and Chinese economies, uncertainty surrounding interest rates, depressed oil prices, and volatility in high yield bond markets were not offset by material strength elsewhere. The yield curve continued to flatten following the first rate hike in December, and the ECB continued its QE while the Bank of Japan recently cut rates to negative. This put upward pressure on the US dollar, tightening the stranglehold on manufacturing and export earnings. Accordingly, markets corrected.

By mid-February, a number of developments helped to stabilize markets. In the immediate term, the S&P 500 held support at 1812, a level bolstered by the fact that market valuations were oversold at those levels. A confluence of positive technical indicators and the influx of computer-driven programs sparked the action. And in the medium term, moderately improved economic data, a rebound in oil and other commodity prices (suggesting commodity price stabilization, and helping to stabilize high yield bond markets), and good corporate pre-announcement news turned the negative feel around in a pronounced fashion.

In the long term, a number of significant concerns persisted heading into April. Corporate profits are anticipated to be weaker in Q2, and the market recouped its losses dramatically despite the global economic indicators failing to improve to the same degree. The story is therefore one of corporate earnings and broad economic strength or lack thereof, as both elements must show enough strength and stability to justify market strength heading into Q2.

The following indicators are representative of the overall economic climate in the first quarter of 2016.

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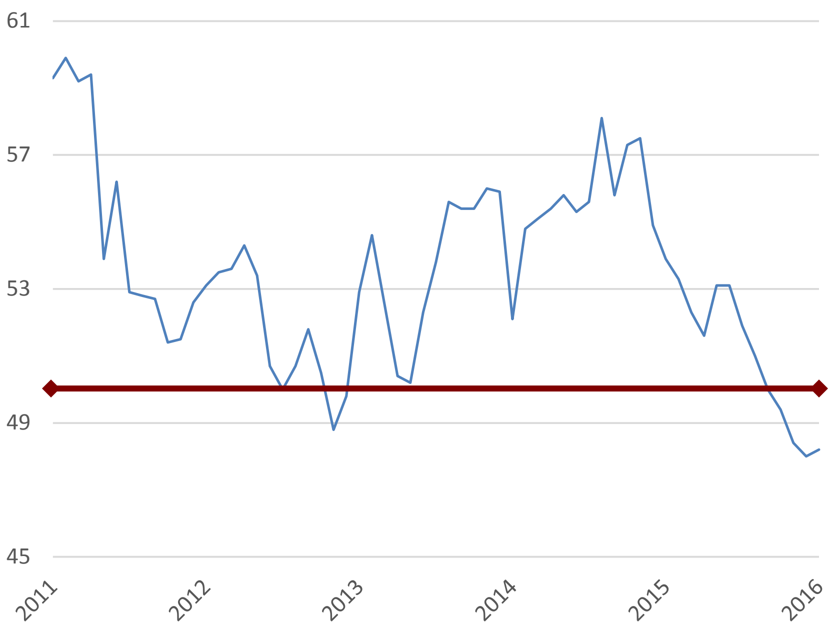
January:

- The economic concerns that persisted toward the end of 2015 failed to improve, and in some cases worsened. US and Chinese manufacturing continued to contract, with China less likely to improve as the country shifts to a more service-based economy. Nonetheless, the 16-month high in the Services PMI index was little consolation as huge leverage in China came to bear. Commodity prices, most notably oil, continued to decline in the face of oversupply with the weakness bleeding into all capital markets. Although the consumer remained healthy, the strong dollar remained a secular concern for US companies.

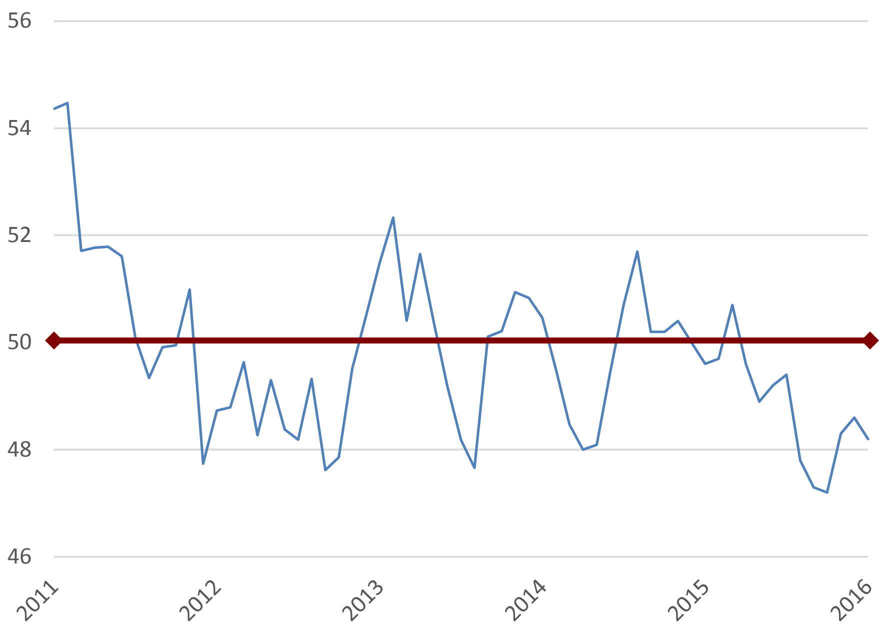
- The S&P 500 index corrected over 5% in January.

- Both US and Chinese manufacturing hovered below the breakeven level of 50, indicating contractionary economic activity in the production sectors of both countries.

ISM Manufacturing Index, January 2011 – January 2016



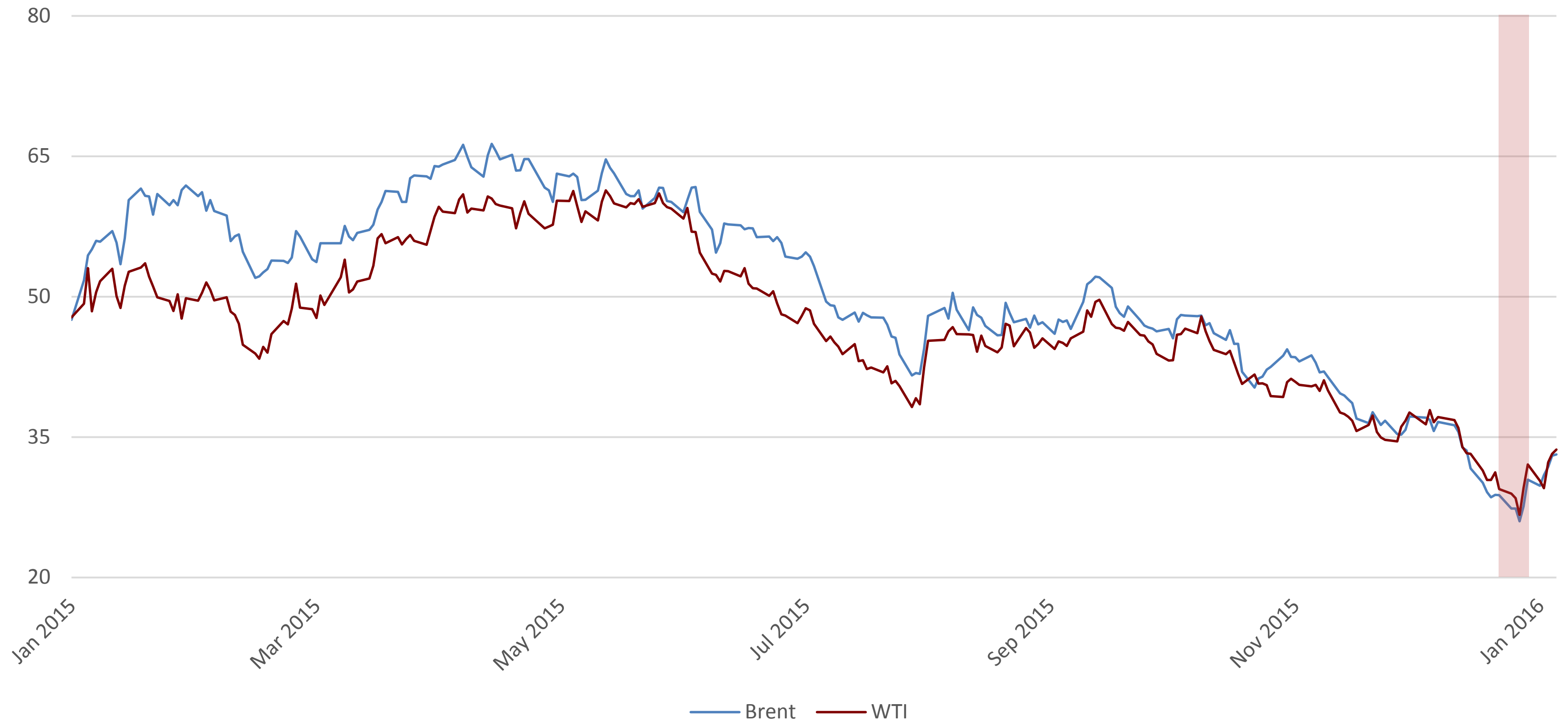
China Manufacturing PMI Survey, January 2011 – January 2016



Q1 Capital Markets Review January

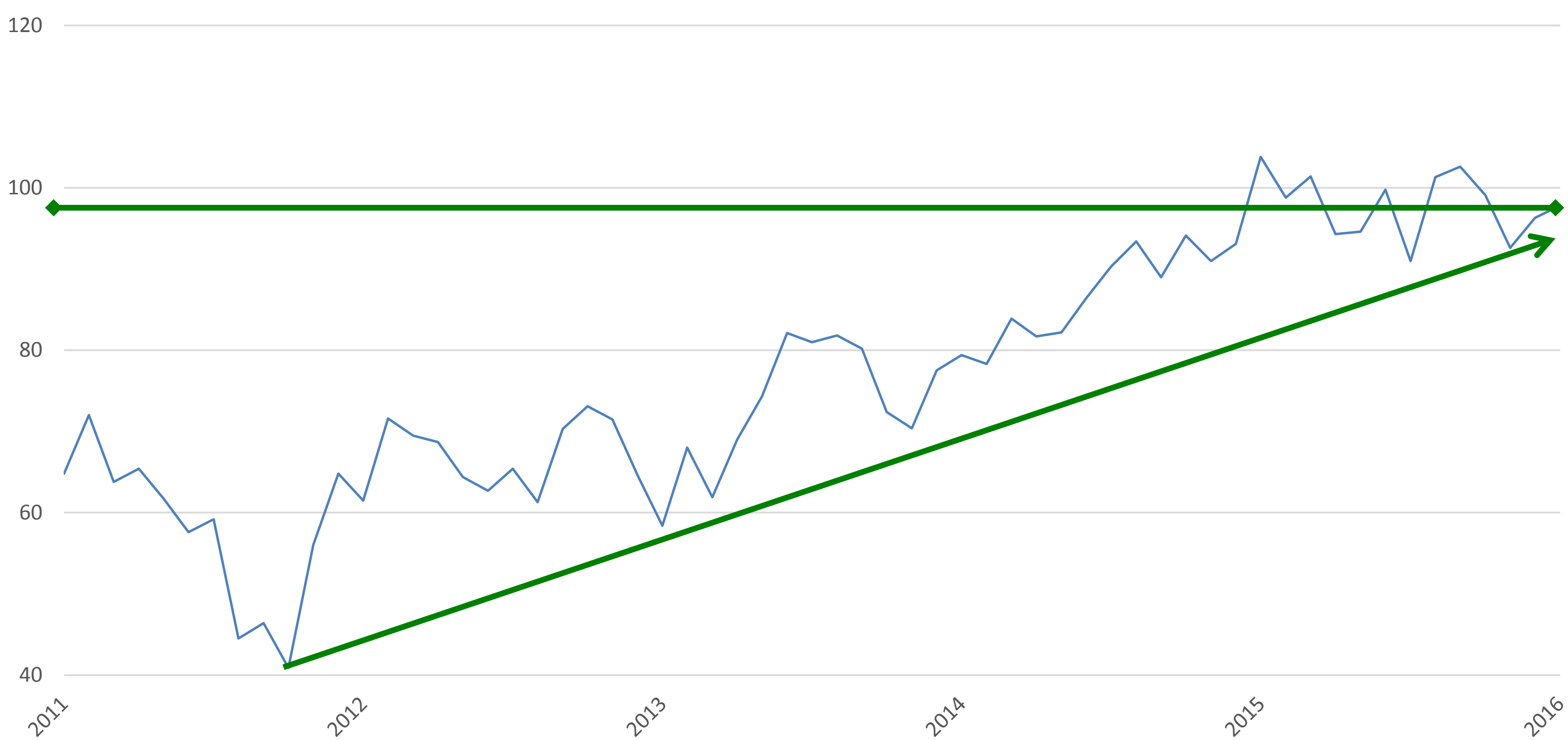
- Crude oil prices dropped below $30/barrel for the first time since 2004, reflecting both extreme global oversupply and a softening of global commodity demand.

Price of Crude Oil, January 2015 – January 2016



- Despite stock market volatility and weakness in the manufacturing sector, consumer confidence remained high as the services and consumer sectors of the US economy remained strong.

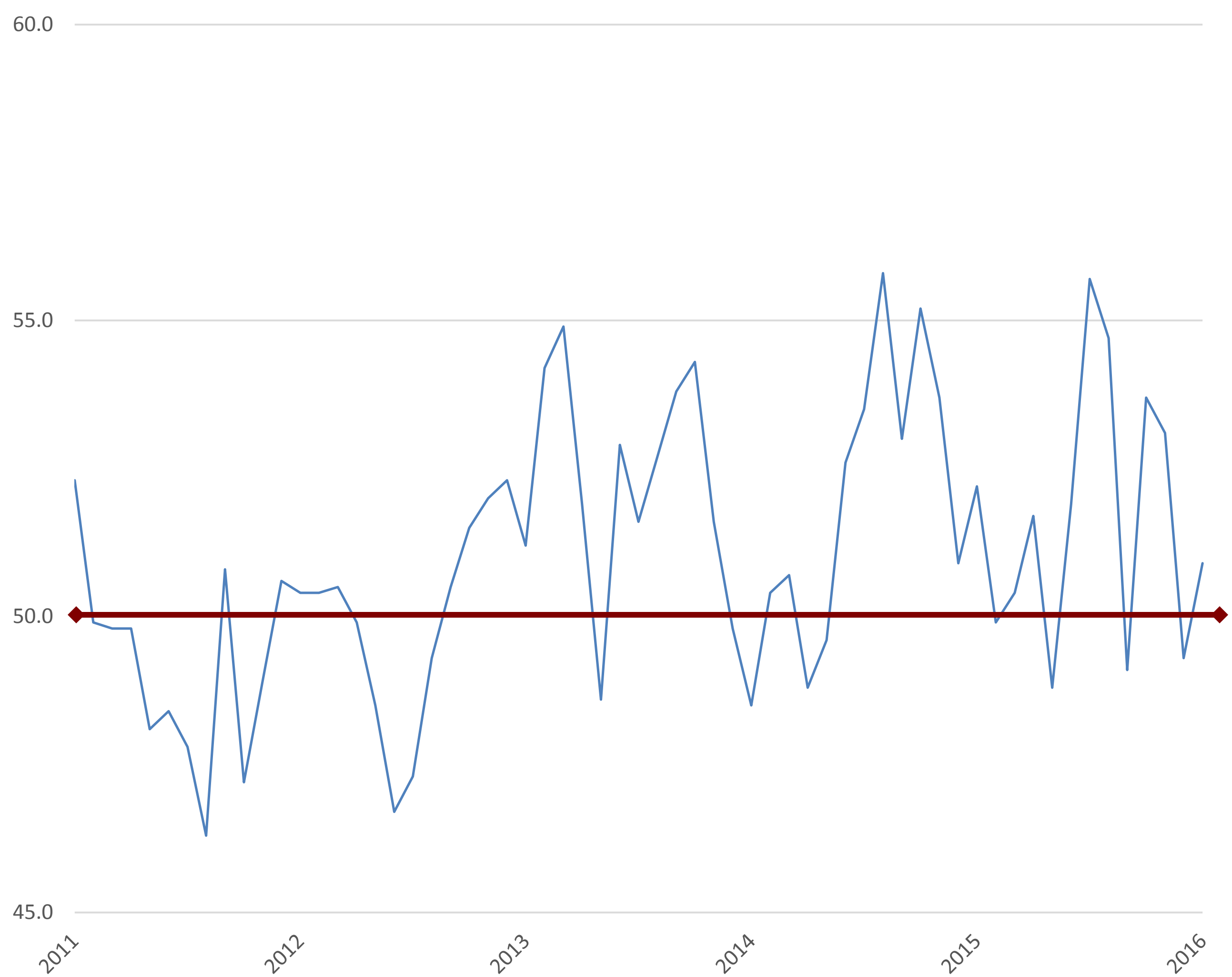
Conference Board Consumer Confidence Index, January 2011 – January 2016



- The Architectural Billings Index entered 2016 below the breakeven point of 50, indicating contraction in future construction activity.

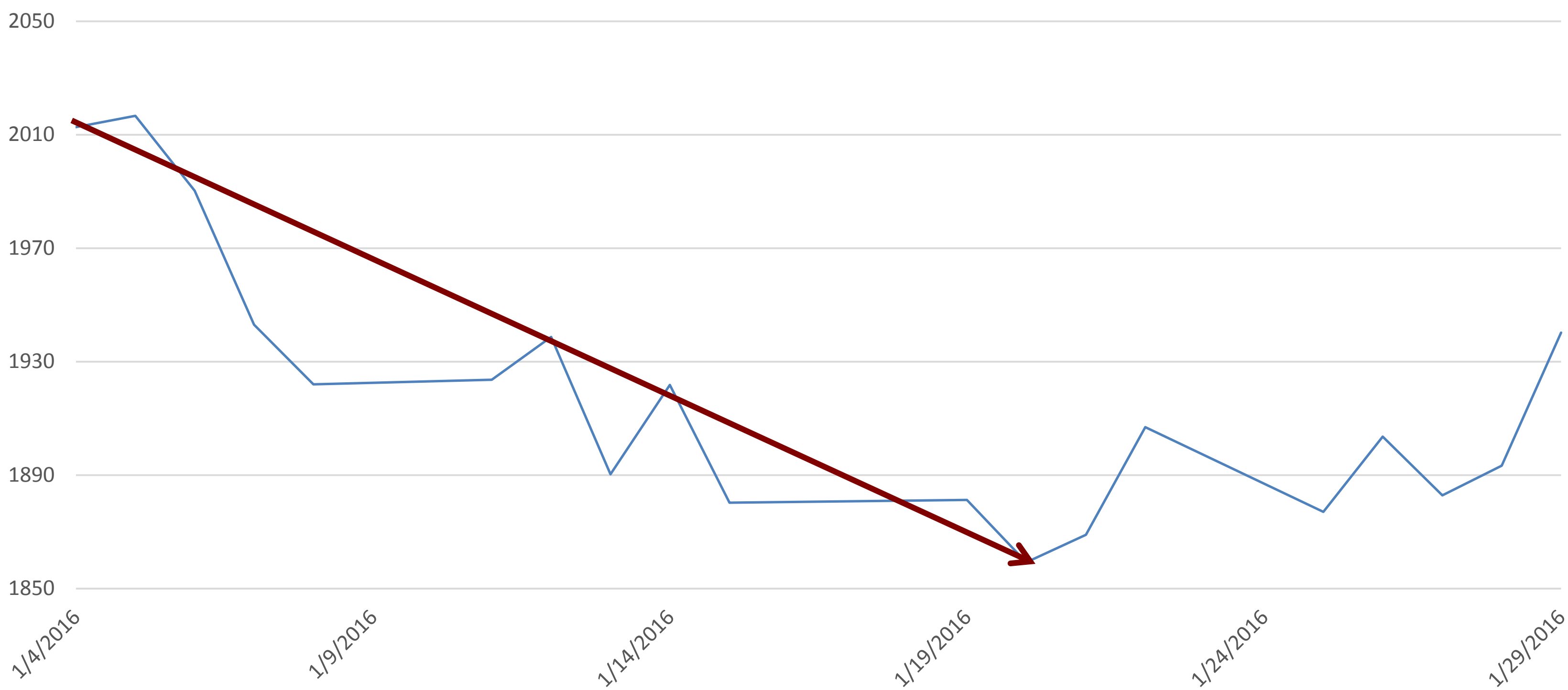
- Although the index bounced above 50 in late January, sustained strength and stability has yet to show.

Architectural Billings Index, January 2011 – January 2016



Q1 Capital Markets Review January

S&P 500 Index, January 2016



- Equity markets declined in the first three weeks of January before bouncing slightly to end the month, swooning to enter the new year on weak data and questionable valuation levels.

February:

- The headline story was oil, as weak oil prices hovered around $30/barrel before bouncing in the second half of the month. Stocks moved 90% in correlation with oil. Credit market spreads continued to widen to levels last seen in the fall of 2011, and the yield curve continued to flatten regardless of assurances from the Federal Reserve that future rate hikes would be gradual. However, although both manufacturing and services conditions in the US and China failed to improve materially, the consumer sector remained relatively healthy and continued to drive the economy.

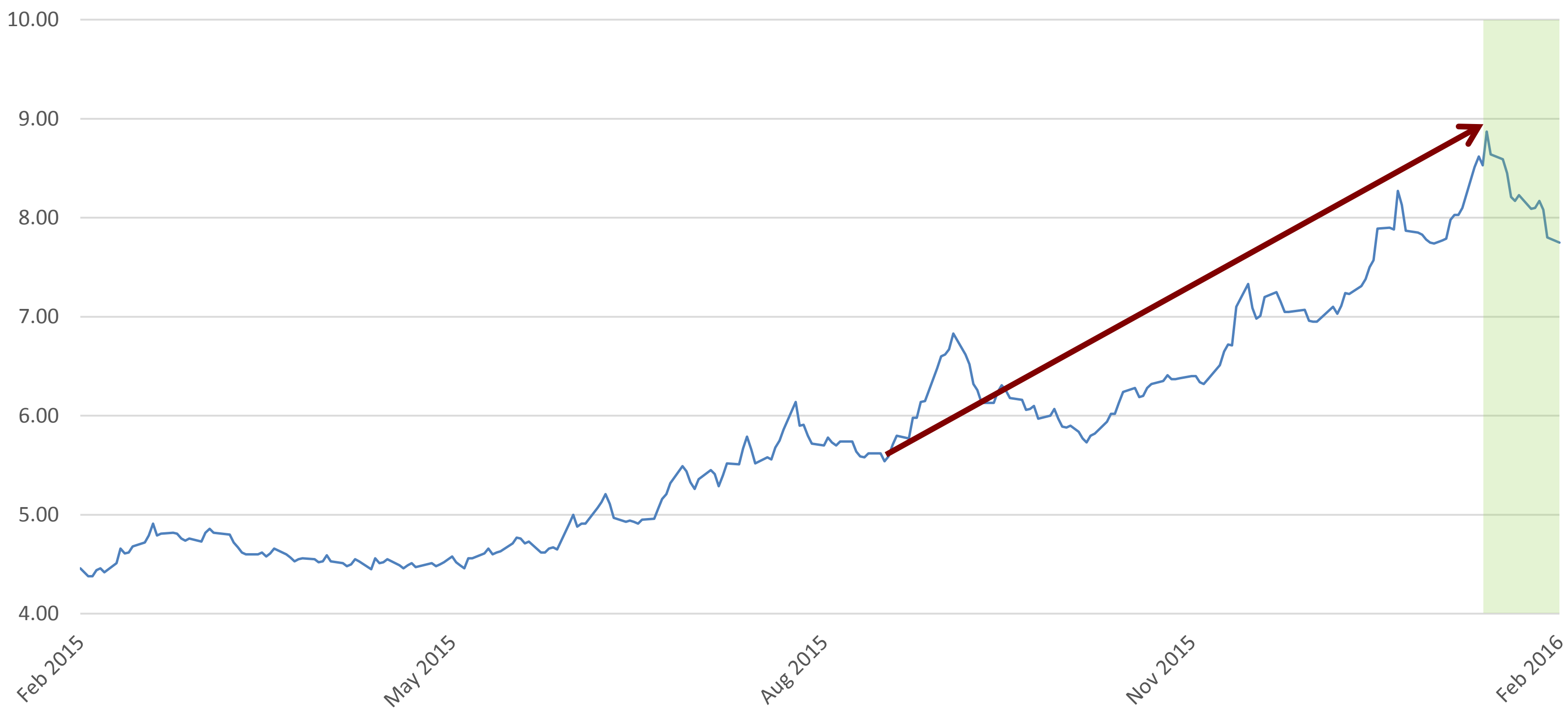
- The bounce in oil helped trigger a market rebound mid-month and the S&P 500 index closed the month down only 41 bps after correcting 5.7% to start the month.

- Crude oil prices stabilized and bounced in February, as Brent crude in particular rebounded strongly in the second half of the month to settle fears of global commodity crisis and spur upside momentum in the broader equity markets.

Price of Crude Oil, February 2015 – February 2016

- After widening during the latter half of 2015 due to the destabilization in the energy markets (which comprise ~25% of high yield credit), high yield spreads stabilized and contracted somewhat in February.

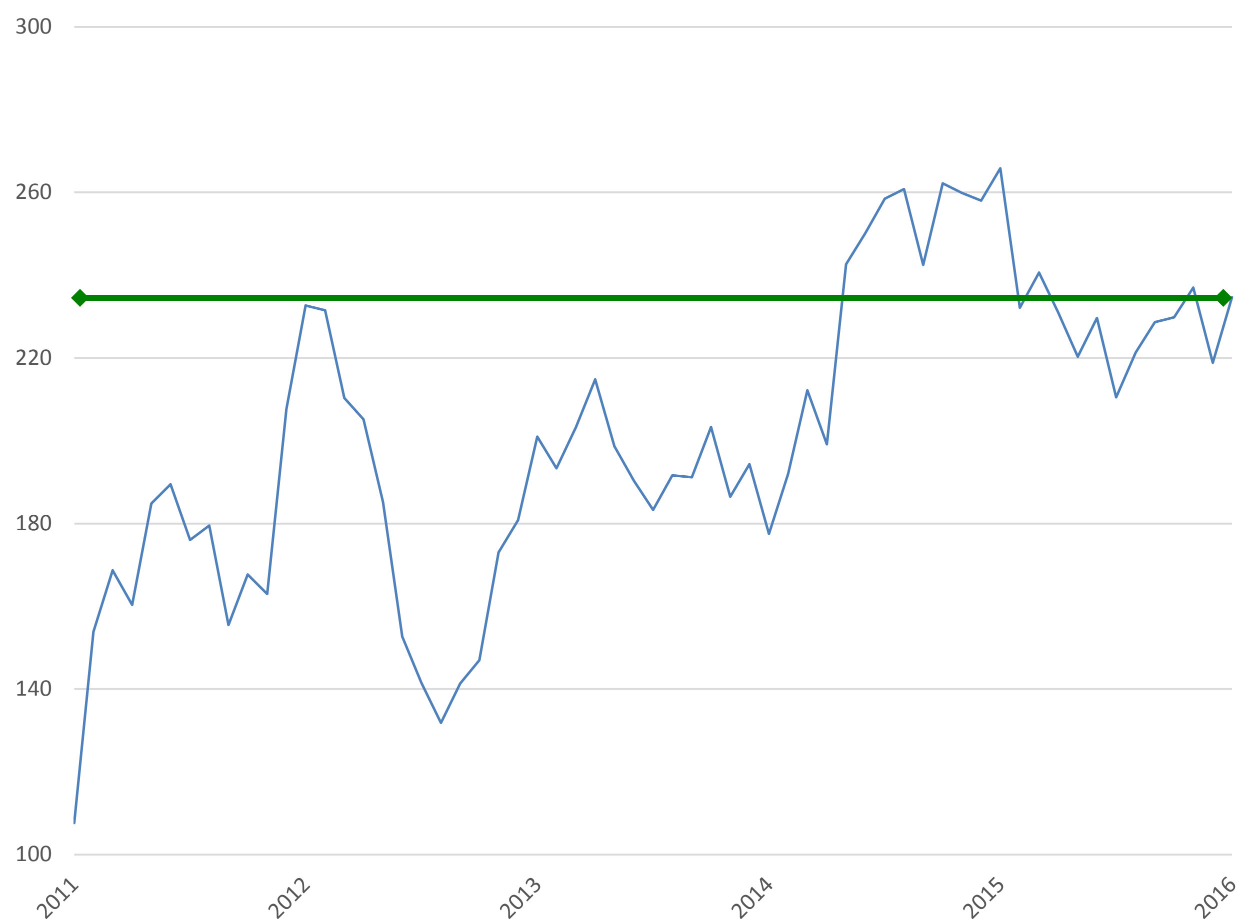
US High Yield Credit Spread, February 2015 – February 2016



Q1 Capital Markets Review February

- The US jobs market stayed steady, lending credence to the notion that the US economy was being supported by the service and consumer sectors.
- Long-term growth in the US jobs market remained healthy in spite of weakness in oil and manufacturing.

US Nonfarm Payroll MoM Change (6-month smoothed), February 2011 – February 2016



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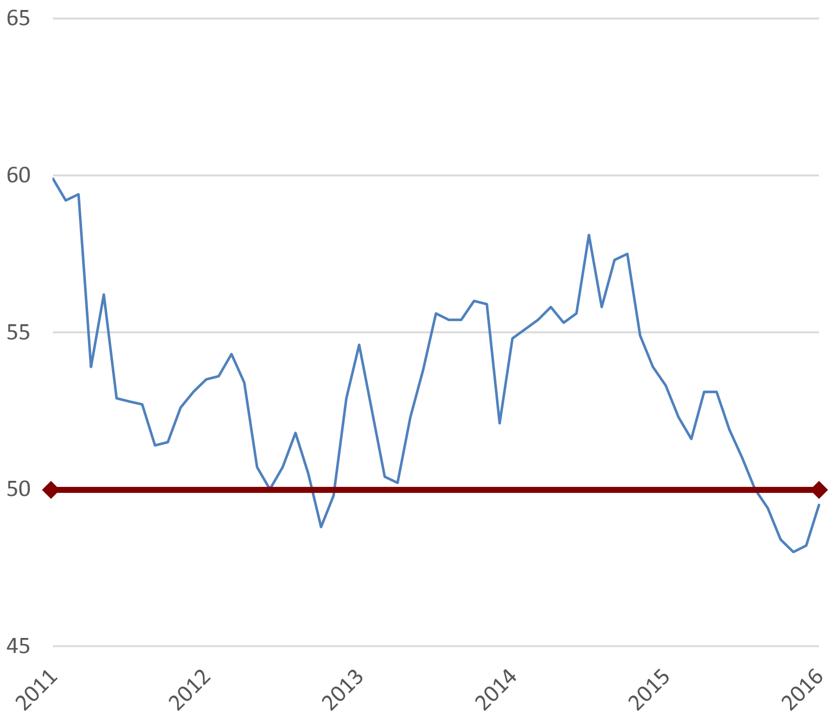
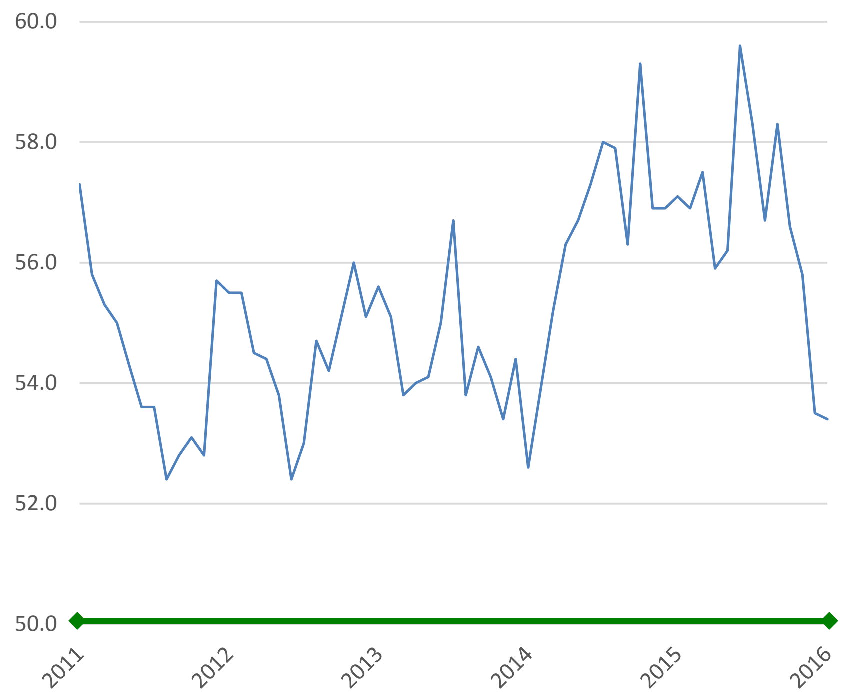
- Although US manufacturing improved in February, it remained contractionary at 49.5 (50 represents breakeven). On the flip side, US services declined nominally MoM but remained expansionary at 53.4.

ISM Manufacturing Index, February 2011 – February 2016



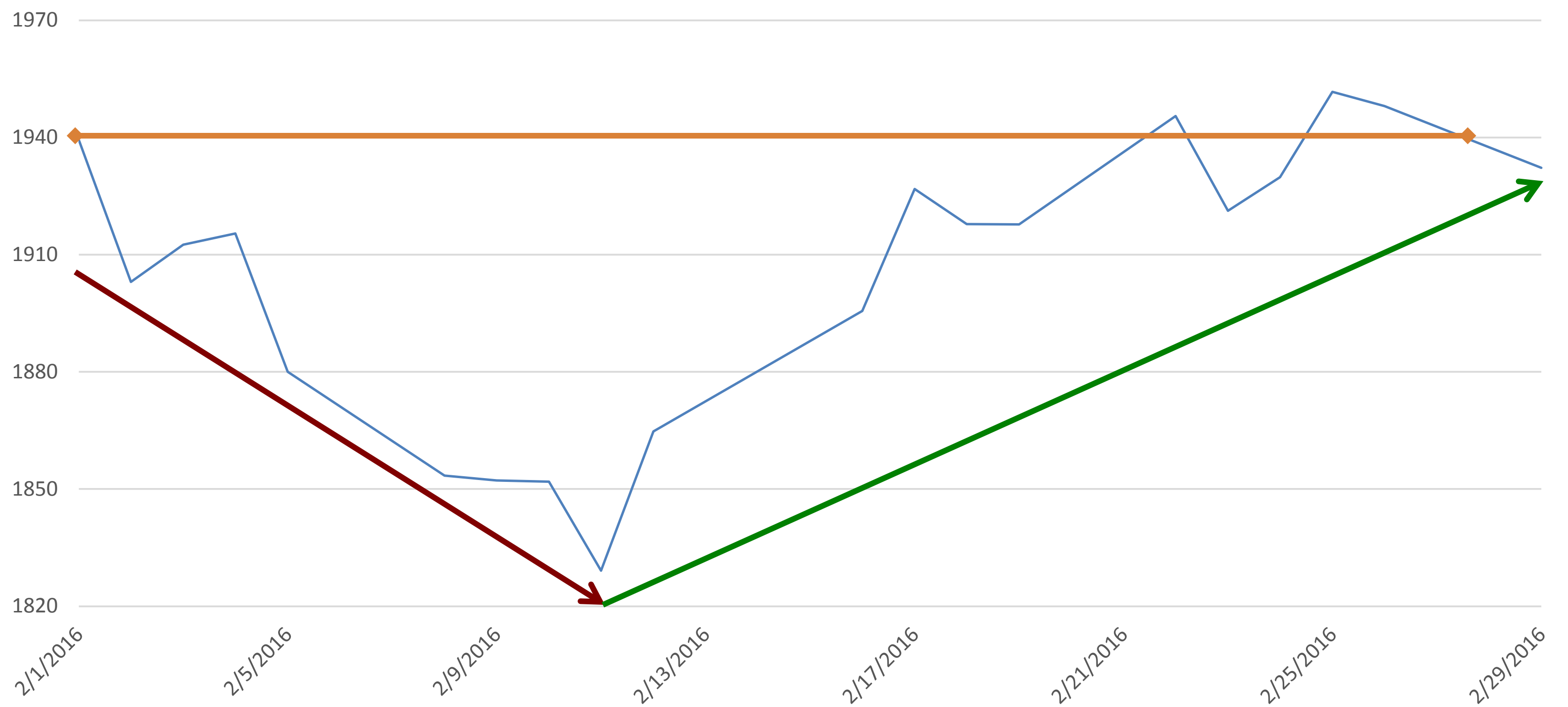
ISM Non-Manufacturing Index, February 2011 – February 2016



Q1 Capital Markets Review February

- Markets continued to decline in the first half of February before rebounding amid a mid-month bounce in oil prices, ending the month ultimately flat.

S&P 500 Index, February 2016



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March:

- After months of contractionary activity, economic conditions finally began to reverse in March. Although economic activity could not yet be classified as "strong," signs of improvement began to show. The ISM manufacturing index broke above 50 as coincident and leading economic activity expanded after several months of contraction. Abroad, weakness in Japan and efforts to stabilize production in China were offset by a steady rate of expansion in the Eurozone. Oil prices also improved as WTI and Brent crude both broke above $40/barrel for the first time since early December. Although the yield curve continued to flatten, composite Treasury yield spreads remained around 1% over breakeven, and Janet Yellen mitigated the concerns over the pace of future rate increases.

- The S&P 500 index rose 6.6% in March.

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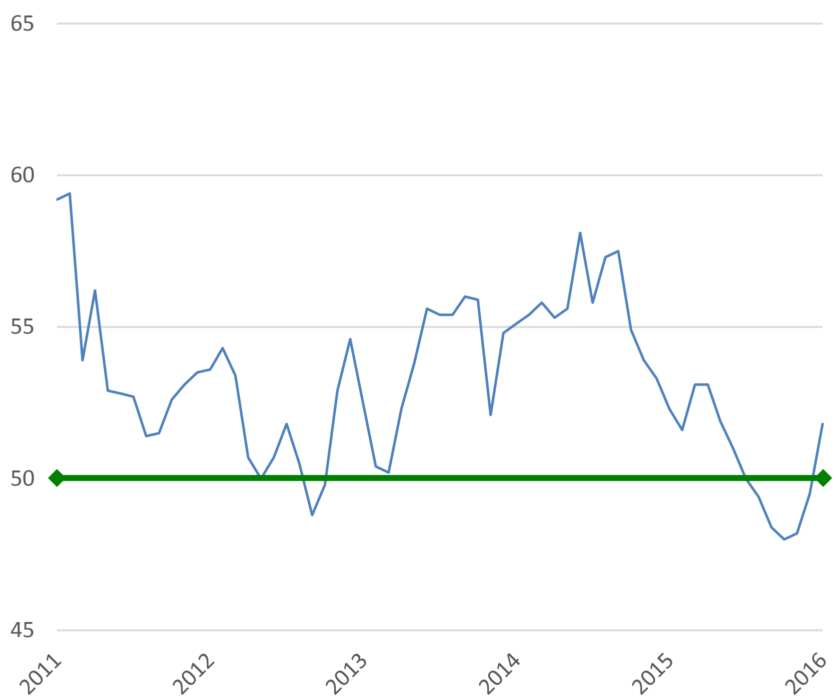
Q1 Capital Markets Review March

- The Treasury yield curve continued to flatten in the first quarter.
- Despite a bounce in the latter part of the month, the yield curve dipped below 1% in March and remained in a long-term flattening trend following December's rate hike.

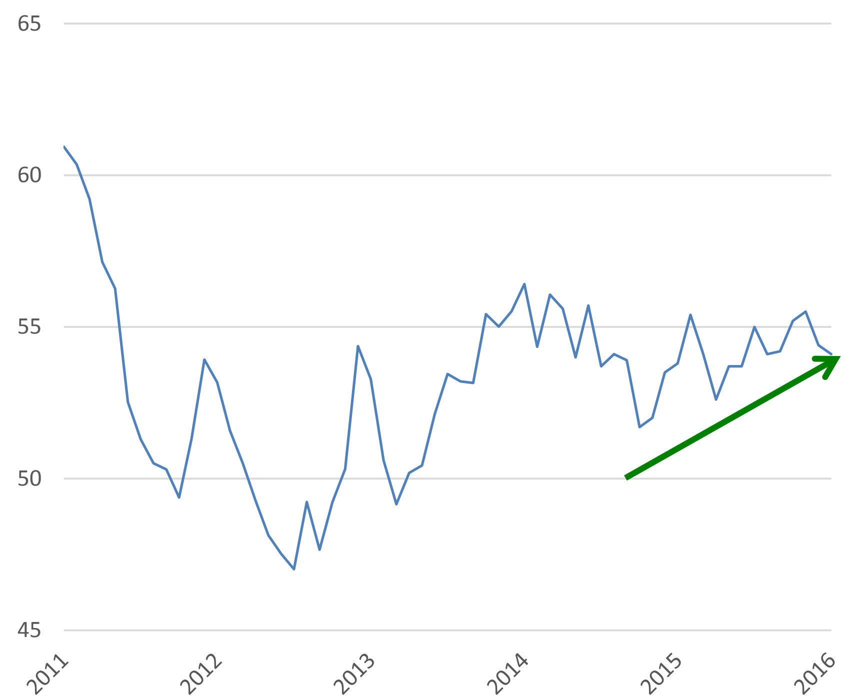
U.S. Treasury Yield Curve (Representative Slope), March 2015 – March 2016

- The ISM manufacturing index finally rose above 50 for the first time since September 2015. Europe remained steady, expanding at a healthy clip throughout the soft patch in the US and China.

ISM Manufacturing Index, March 2011 – March 2016



Germany Composite PMI Survey, January 2011 – January 2016



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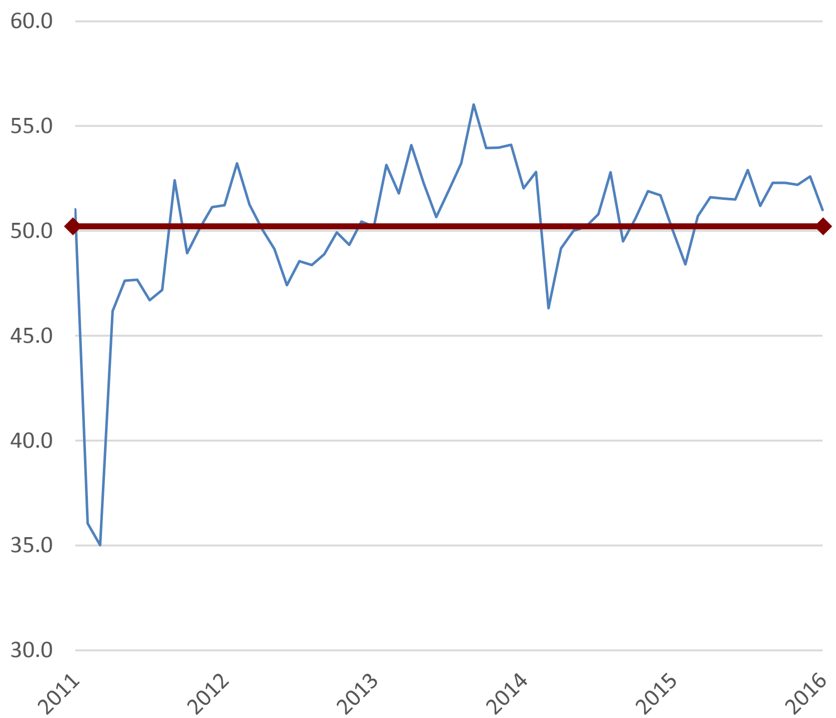
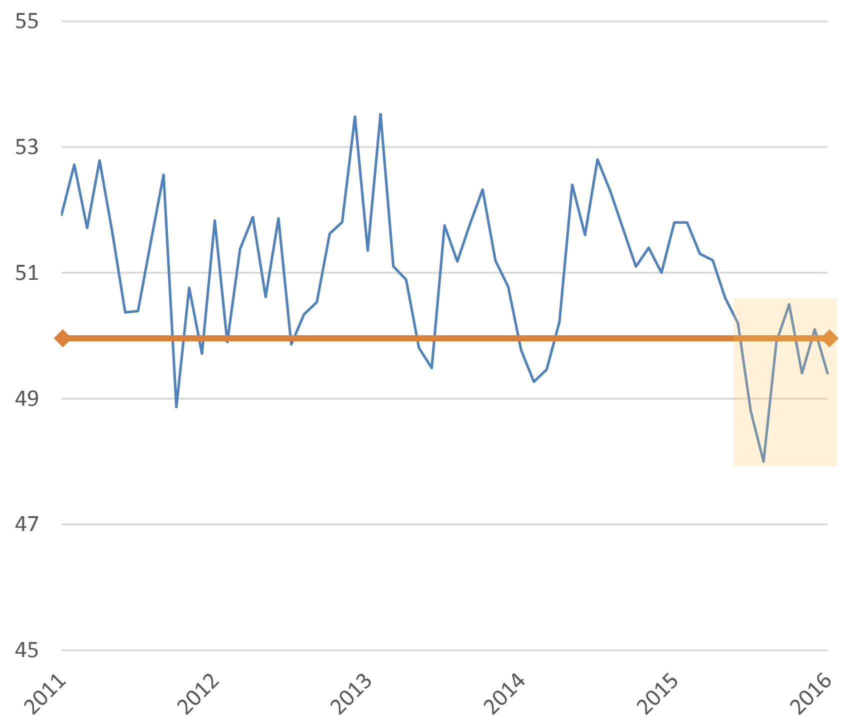
- Japanese production hovered around breakeven while GDP was around zero during the first quarter. Ongoing weakness in Japan was somewhat mirrored in China, which continued to hover within a point of 50 for the fifth straight month.

Japan Composite PMI Survey, March 2011 – March 2016



China Composite PMI Survey, January 2011 – January 2016



CBOE Equity Put/Call Ratio (smoothed), March 2015 – March 2016

- The ratio of puts to calls peaked in January as option activity began to tilt in a more bullish direction.

- The improvement in market technical indicators ultimately anticipated the turnaround in equity markets beginning in the second half of February and lasting through March.

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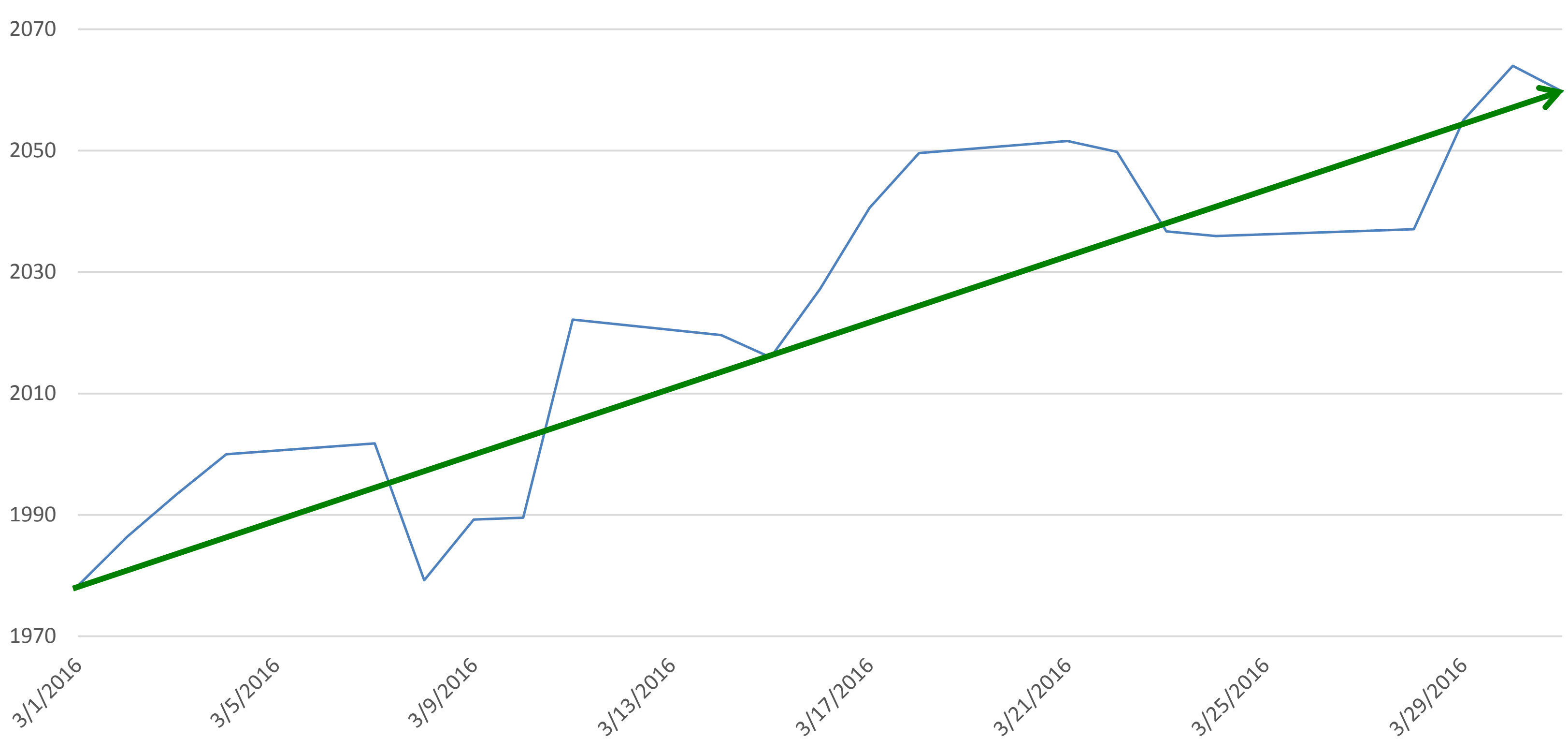
- The S&P 500 climbed almost straight up in March as reassuring comments from Janet Yellen and signs of economic stabilization pushed market higher.

S&P 500 Index, March 2016



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Global Economic Indicator Descriptions

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

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

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

The Germany Composite PMI Survey is a survey-based measure of manufacturing conditions in Germany.

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

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

Conference Board Consumer Confidence Index is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

Architectural Billings Index is a leading economic indicator of demand for commercial and industrial building activity.

Japan Composite PMI Survey is a survey-based measure of manufacturing conditions in Japan.

CBOE Equity Put/Call Ratio shows the data for the put and call volumes for equity, index and total options.

Global Economic Indicator Descriptions

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 US Treasury Yield Curve is the difference between the short and long ends of the yield curve for United States Treasuries.

The US Nonfarm Payroll MoM Change report is a measure of the monthly change in the number of employed persons in the US as estimated by a survey of approximately 60,000 households.

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

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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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Data for global economic indicators has been provided by various sources. Data for the S&P 500 index has been provided by the Federal Reserve Bank of St. Louis.

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