Q4 Capital Markets Review

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Q4 Capital Markets Review

The fourth quarter of 2013 was an exceptionally strong quarter in terms of fundamental economic conditions. Minor concerns over peripheral economic indicators, technical market indicators, and headline news were offset by strong core indicators. Accordingly, the S&P 500 index experienced gains in excess of 9%.

Entering the fourth quarter, an imminent US government shutdown dominated news headlines. As the government shut down, the S&P 500 reacted with a week or so of declines. Soon, however, our global economic indicators – which had continued to strengthen as the fiasco in Washington raged – regained headline traction, and the market reversed into gains.

With several minor exceptions, economic strength continued throughout the quarter. Two notable instances caused us minor concern: first, at the start of November, the ECB cut interest rates due to unexpectedly poor inflation, and the yield on the 10 Year US Treasury Bill jumped simultaneously. This turned out to be nothing more than a hiccup. Second, several technical market indicators showed flashes of increased risk. This, too, turned out to be a false alarm, though some of these risks carried over into the new year, and we continue to monitor them.

Other core data such as manufacturing, credit markets, and crude oil prices became stronger or remained strong as the quarter progressed. The S&P 500 followed suit, and we experienced an equity bull market strongly supported by economic fundamentals.

The following indicators are representative of the overall economic climate in the fourth quarter of 2013.

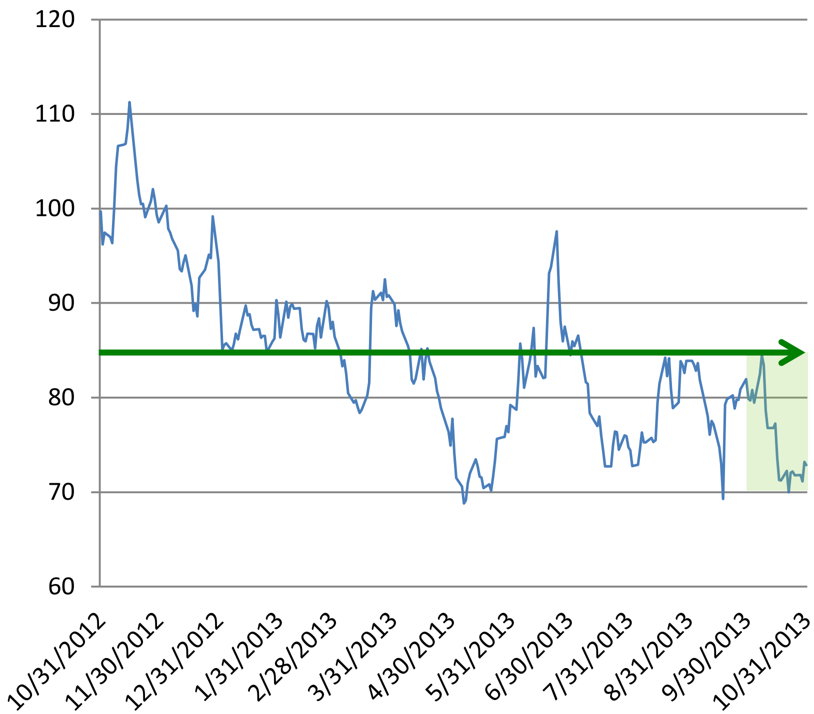
October:

- The US government shut down on October 1 through October 16. After the first week of the shutdown, which was less harmful than anticipated, attention re-focused on fundamental data as the S&P 500 index reversed into gains after a week of correction. We viewed the shutdown as empty noise and remained focused on our global economic indicators.

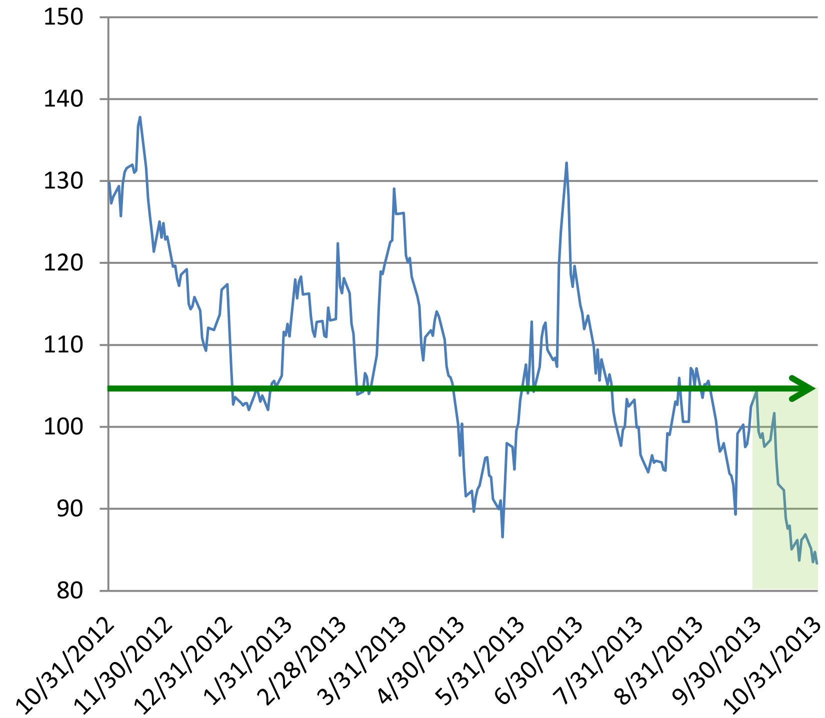
- Strong economic conditions led us to invest heavily in equities. Specifically, we invested in cyclical stocks, which are typically responsive to macroeconomic conditions.

- Heading into Q4, credit risk remained at relatively low levels, despite a minor uptick in September. Credit risk in most markets* declined steadily throughout the month of October.

North American Credit Market Risk, 10/31/12 – 10/31/13



European Credit Market Risk, 10/31/12 – 10/31/13



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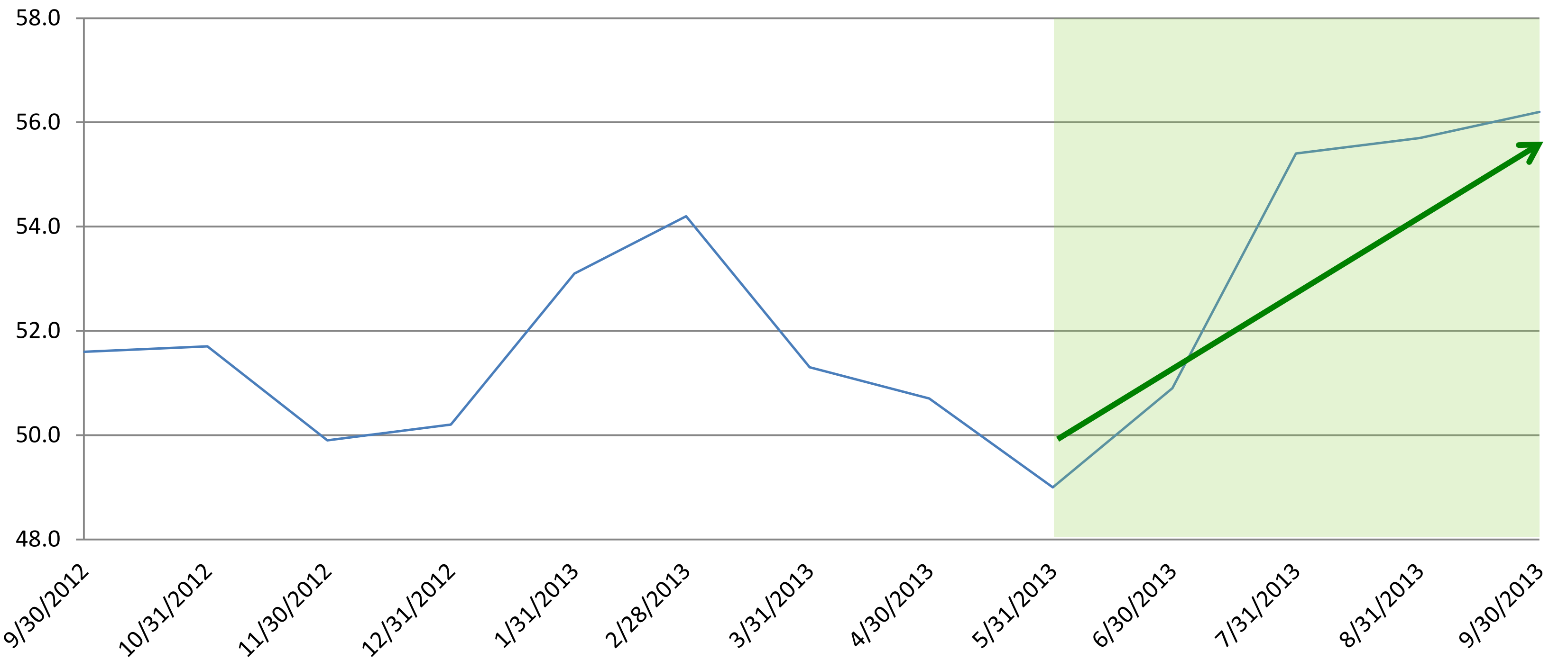
**Credit risk in the more risky emerging markets increased in October due to the uncertainty surrounding the US government shutdown, but risk returned to previously low levels following the government's re-opening.*

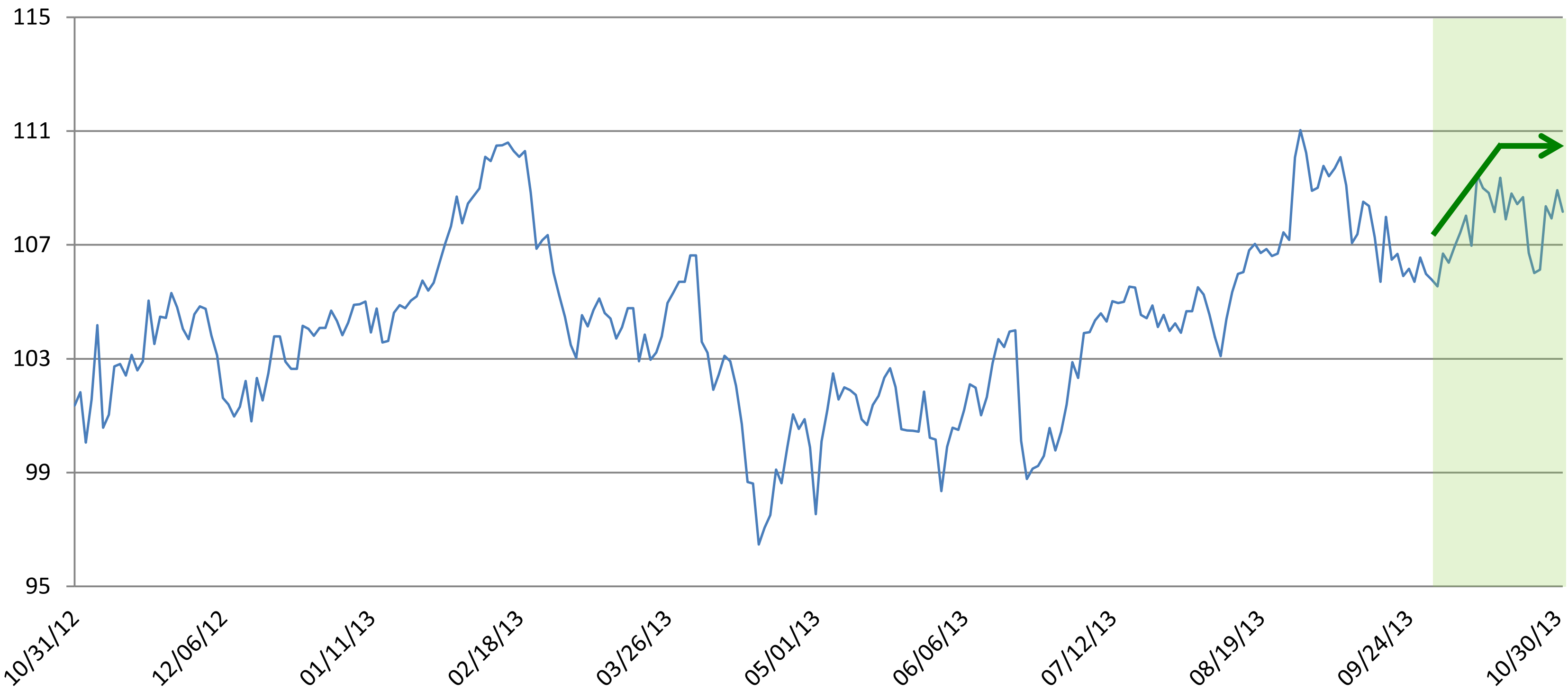
- US manufacturing conditions continued to improve heading into October, building on two-year highs in Q3.

ISM Manufacturing Index, 9/30/12 – 9/30/13



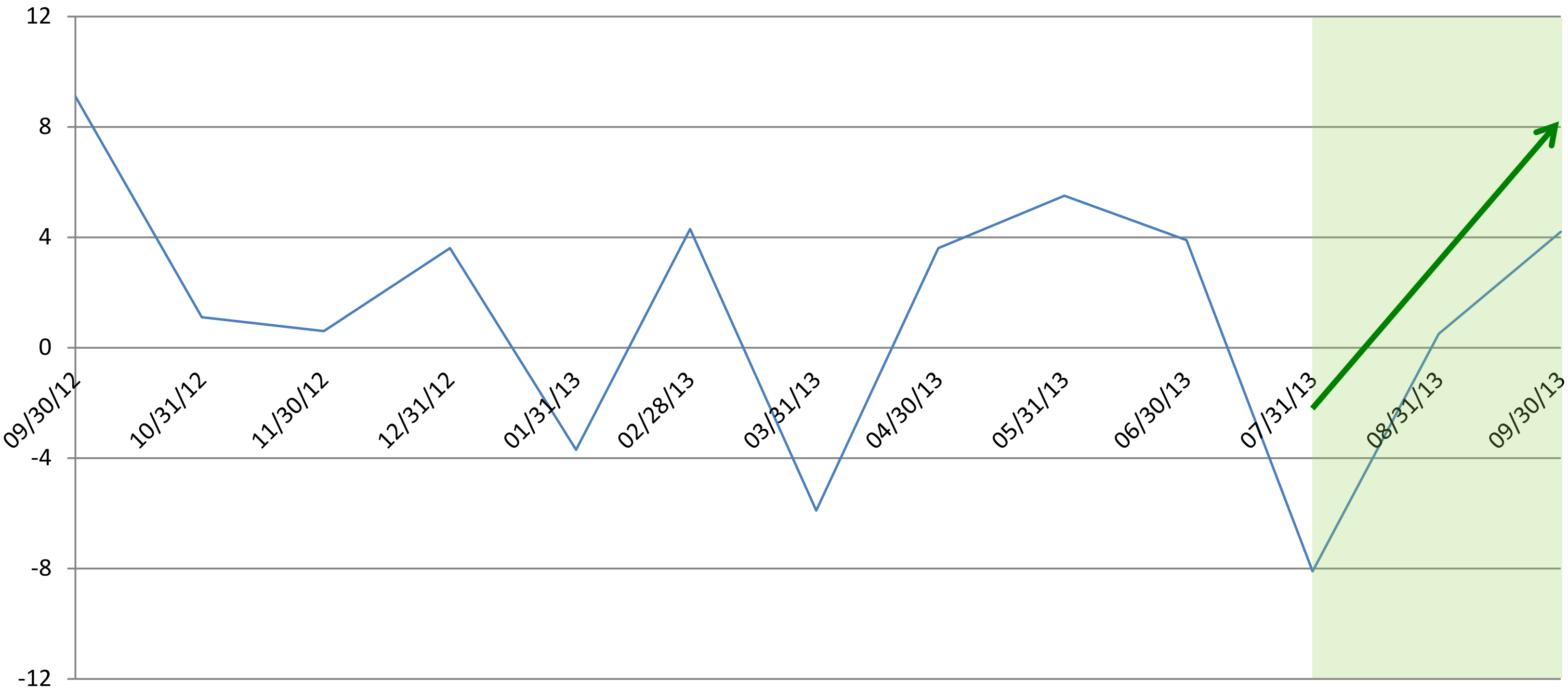
- Global crude oil prices were mostly flat to positive in the month of October, holding steady at high September end-levels.
- Higher oil prices indicate a potential increase in demand for energy consumption.

Price of Brent Crude Oil, 10/31/12 – 10/31/13



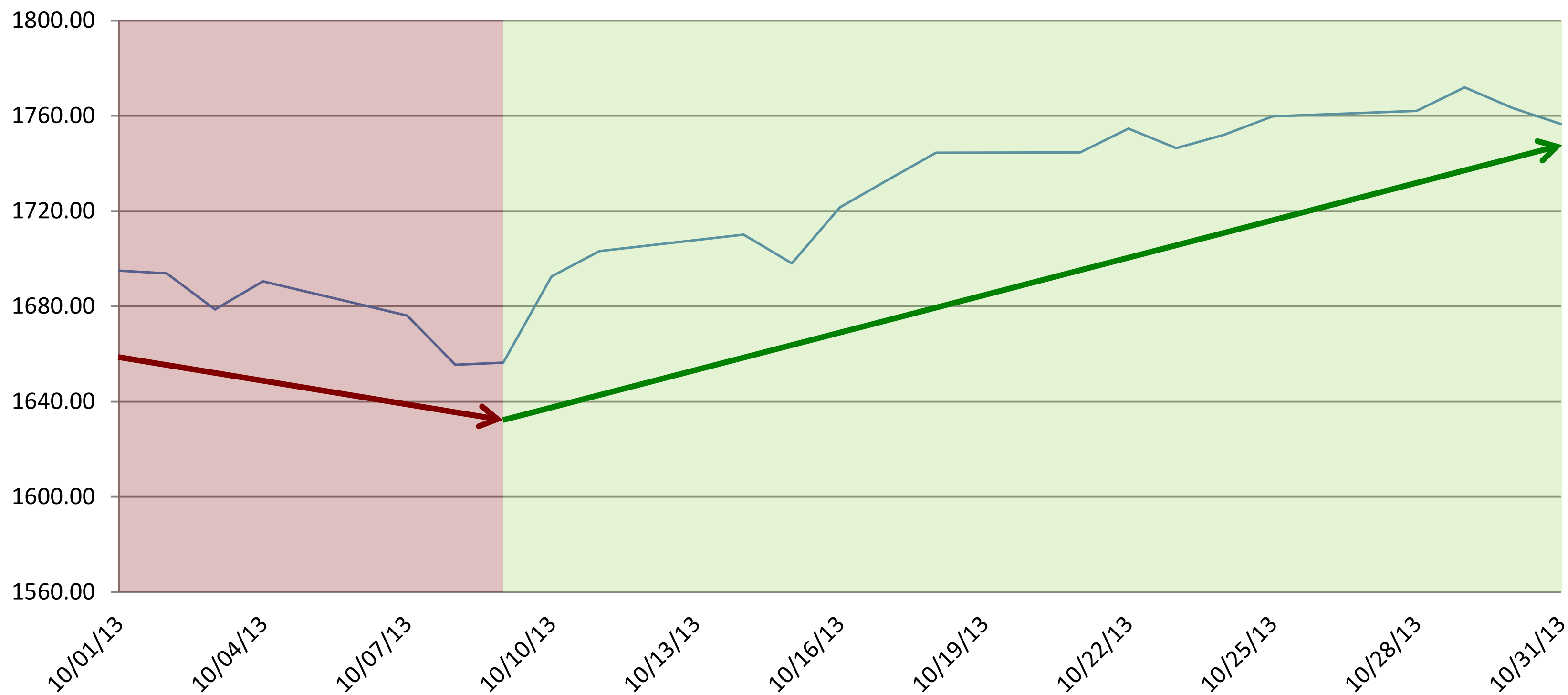
- US durable goods orders increased in August and September heading into October, holding steady near 12-month highs.

US Durable Goods Orders MoM Change, 9/30/12 – 9/30/13



- Following a week of uncertainty because of the government shutdown, the S&P 500 index rallied to end the month of October with gains in excess of 4%.

S&P 500 Index, October 2013



November:

- Heading into November, risk levels remained low and negative headline news was minimal as the government had resumed operations and our global economic indicators remained strong. The S&P accordingly gained approximately 2.5% during the month.

- On November 7, the ECB cut its benchmark refinancing rate to 0.25% from 0.5% following low European inflation numbers. Simultaneously, the yield on the 10 Year US Treasury Bill jumped to ~2.75% from ~2.6% overnight. We reacted quickly to these moves by raising some cash and taking a market short position as a hedge. However, when it became apparent that these were insubstantial hiccups, we re-invested at previously robust levels.

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- After gradual declines in September and October, US Treasury bond yields ticked up in November.
- Traditionally, higher US bond yields indicate increased appetite for risky stocks. However, sharp moves up or down (re: Nov. 7 – highlighted) may imply increased risk.

US 10-Year Treasury Bond Yield, 11/30/12 – 11/30/13

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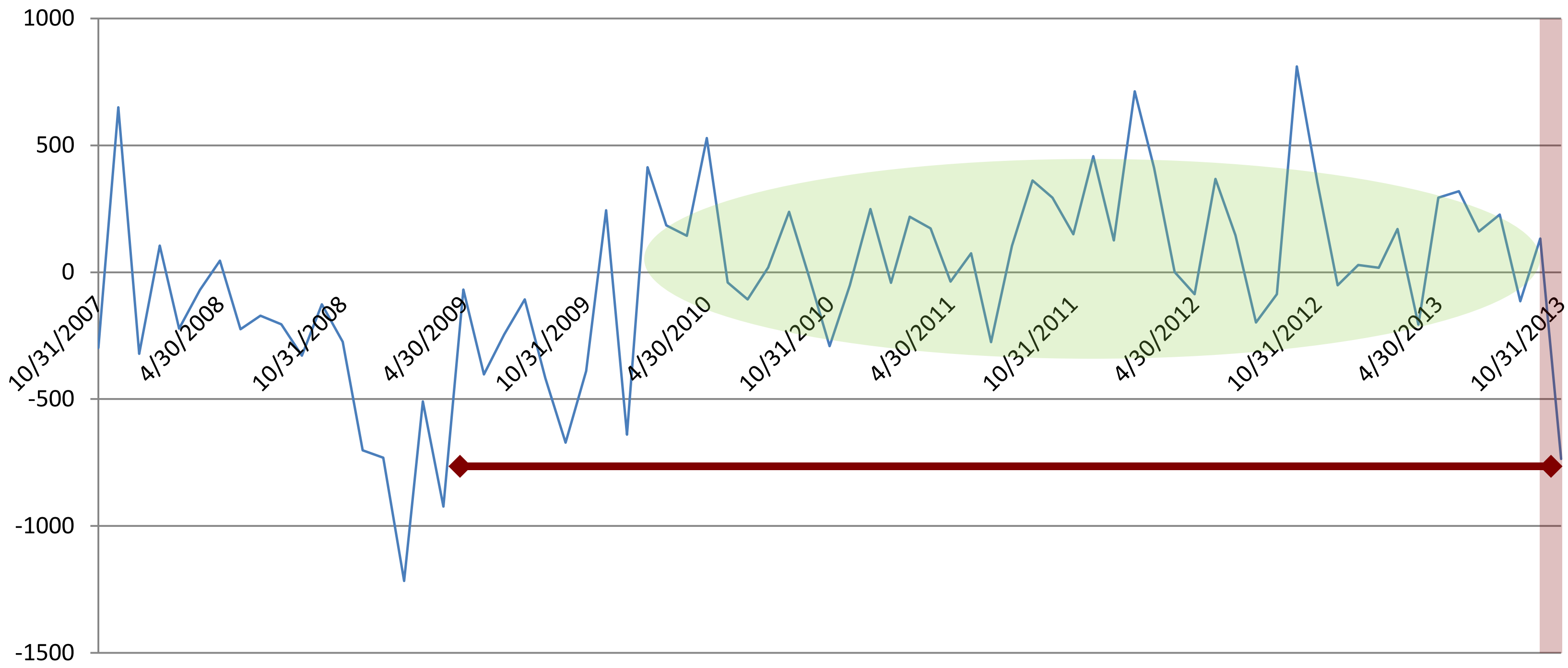
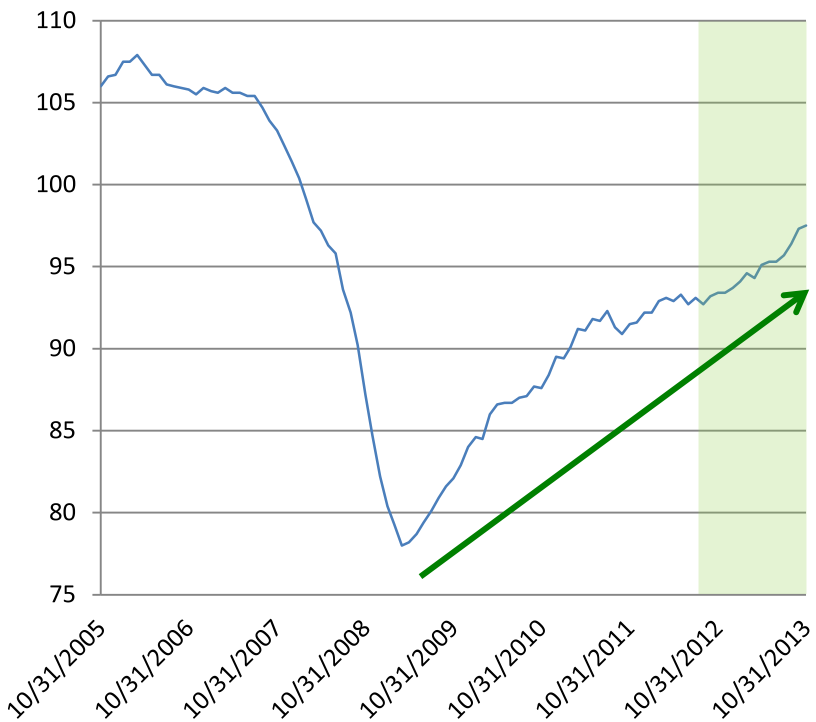
- After over 3 years of adding jobs or staying mostly flat, the United States experienced its worst single-month job loss since March 2009 in October (heading into November).
- This massive loss of jobs was due to the government shutdown and, therefore, temporary.

US MoM Change in Labor Force (CPS), 10/31/07 – 10/31/2013

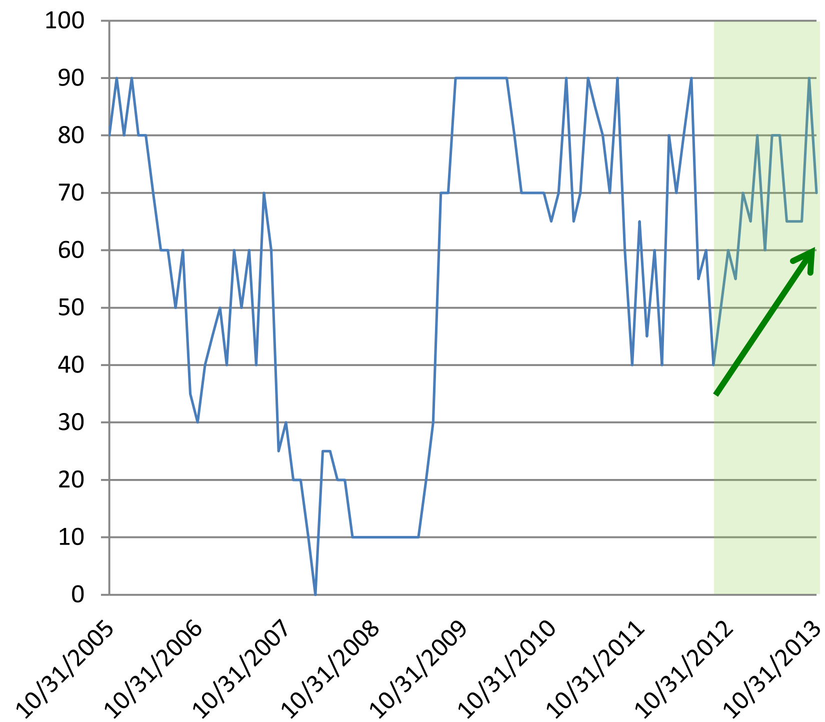


- The Leading Economic Index continued its steady ascent from mid-2009 lows, but more significant was the diffusion index, which showed steadily increasing breadth.

Conference Board LEI Headline Index, 10/31/05 – 10/31/13



Conference Board LEI Diffusion Index, 10/31/05 – 10/31/13



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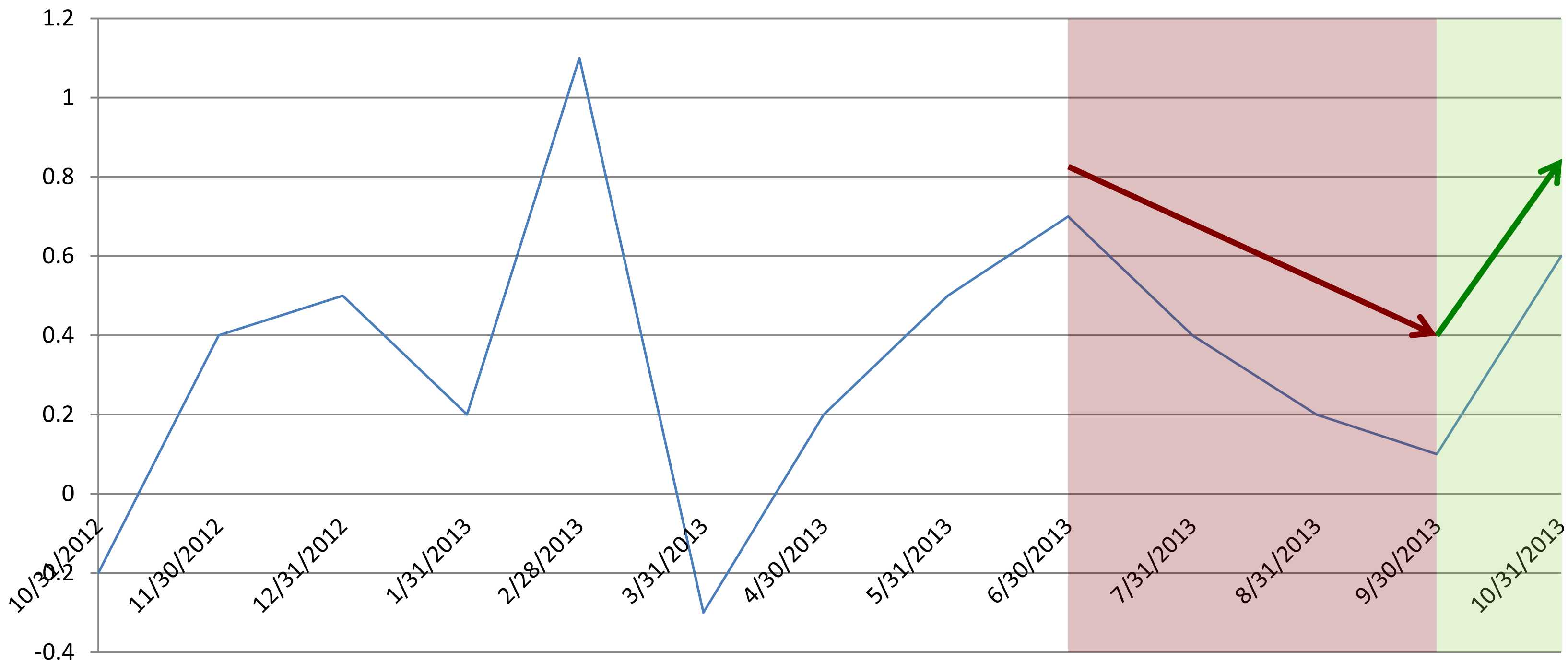
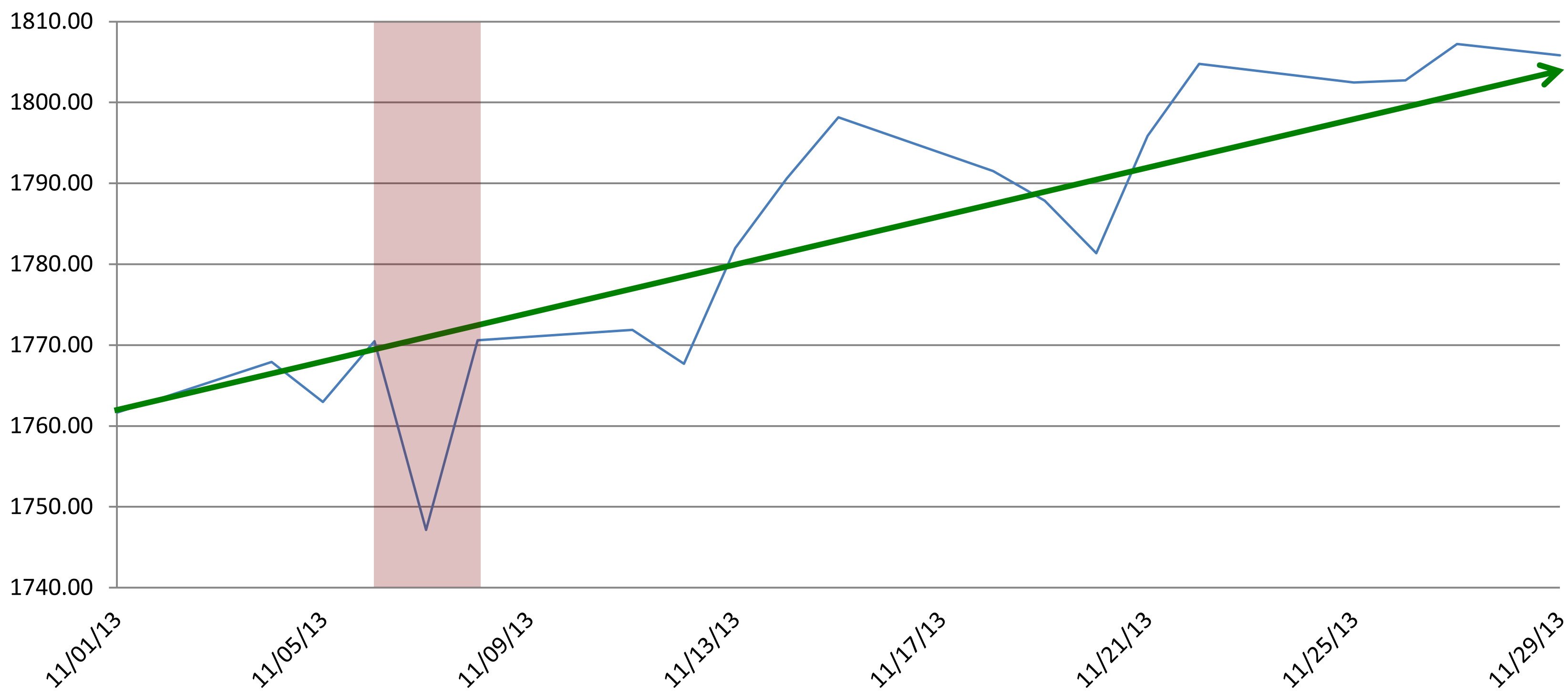
- After several consecutive months of decline, US Retail Sales improved relatively significantly heading into November.

US Retail Sales MoM Change, 10/31/2012 – 10/31/2013



S&P 500 Index, November 2013



- The S&P 500 gained steadily in November as worries over European inflation and Treasury yields turned out to be ephemeral.

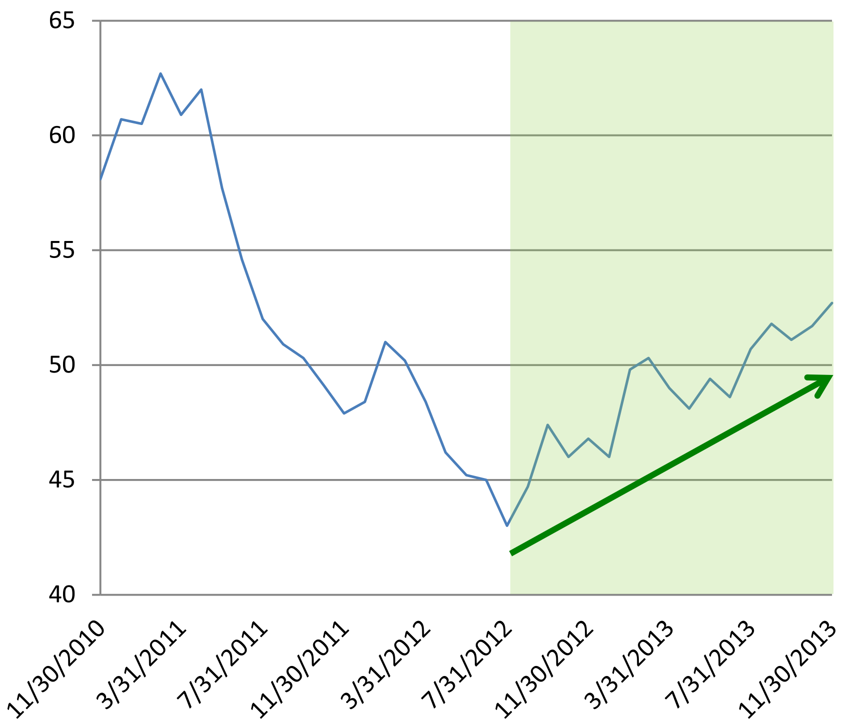
December:

- Headline news in December was mostly limited to the Federal Reserve's decision to taper its bond-buying program (which was tempered by low interest rates going forward). The market absorbed the taper and continued to move higher, seemingly unaffected.

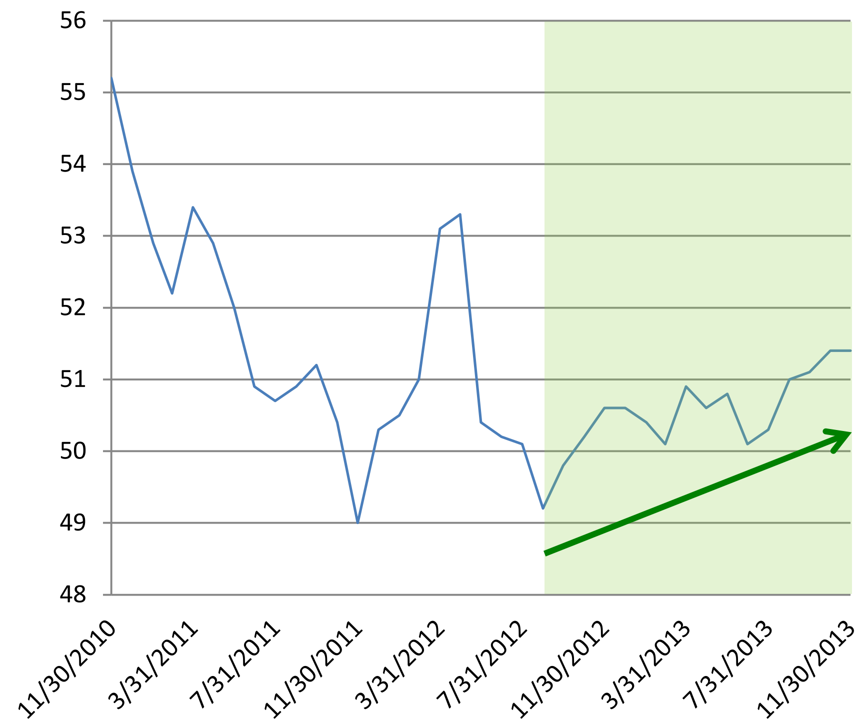
- Entering December, our global economic indicators showed deep and broad strength. As the month wore on, most of our core indicators stayed strong, but several peripheral indicators weakened mildly. Crude oil prices came down from high levels, and several technical indicators – particularly the CBOE equity put/call ratio – showed flashes of risk. Though we did not feel compelled to reduce our exposure to equities, we continued to monitor these risks into 2014 in case of escalation. The overall economic environment, however, closed out the year strongly.

- Heading into December, global manufacturing conditions continued to steadily strengthen.

Germany Manufacturing PMI Survey, 11/30/10 – 11/30/13



China Manufacturing PMI Survey, 11/30/10 – 11/30/13



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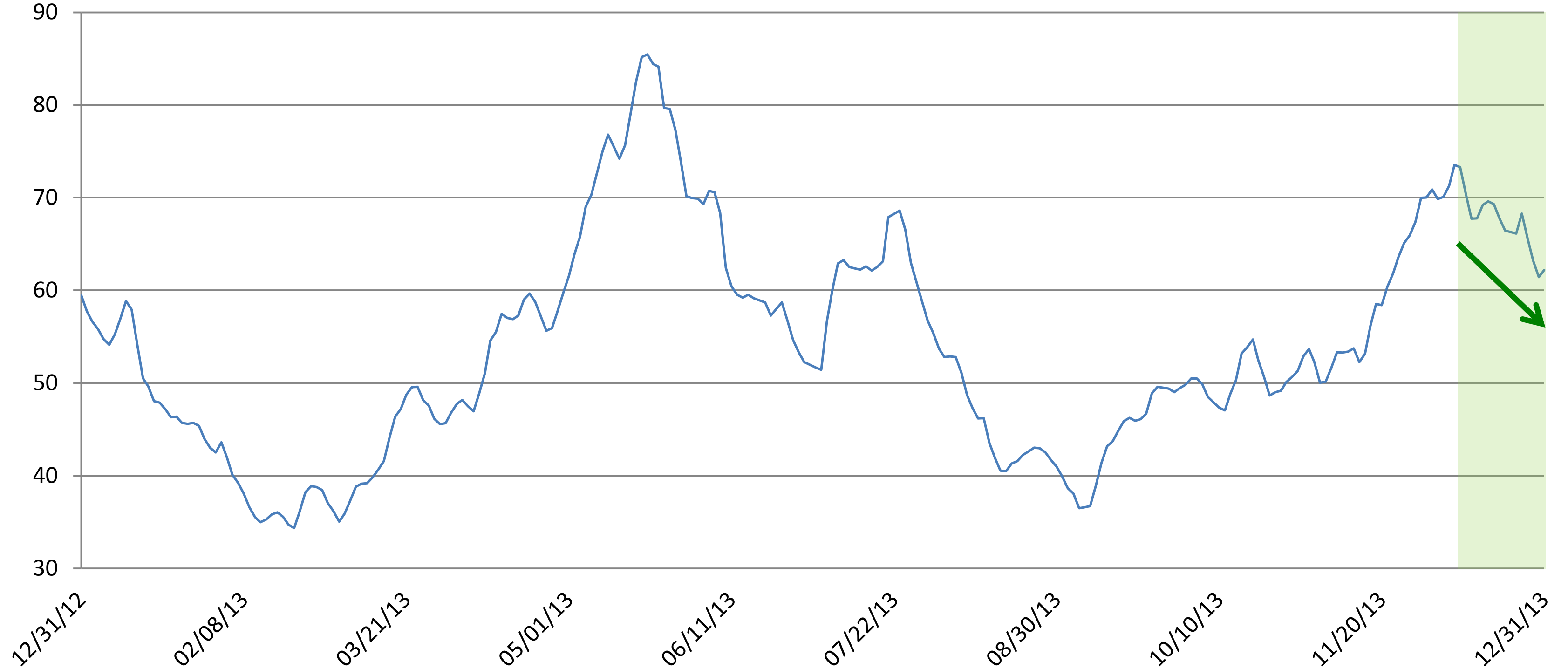
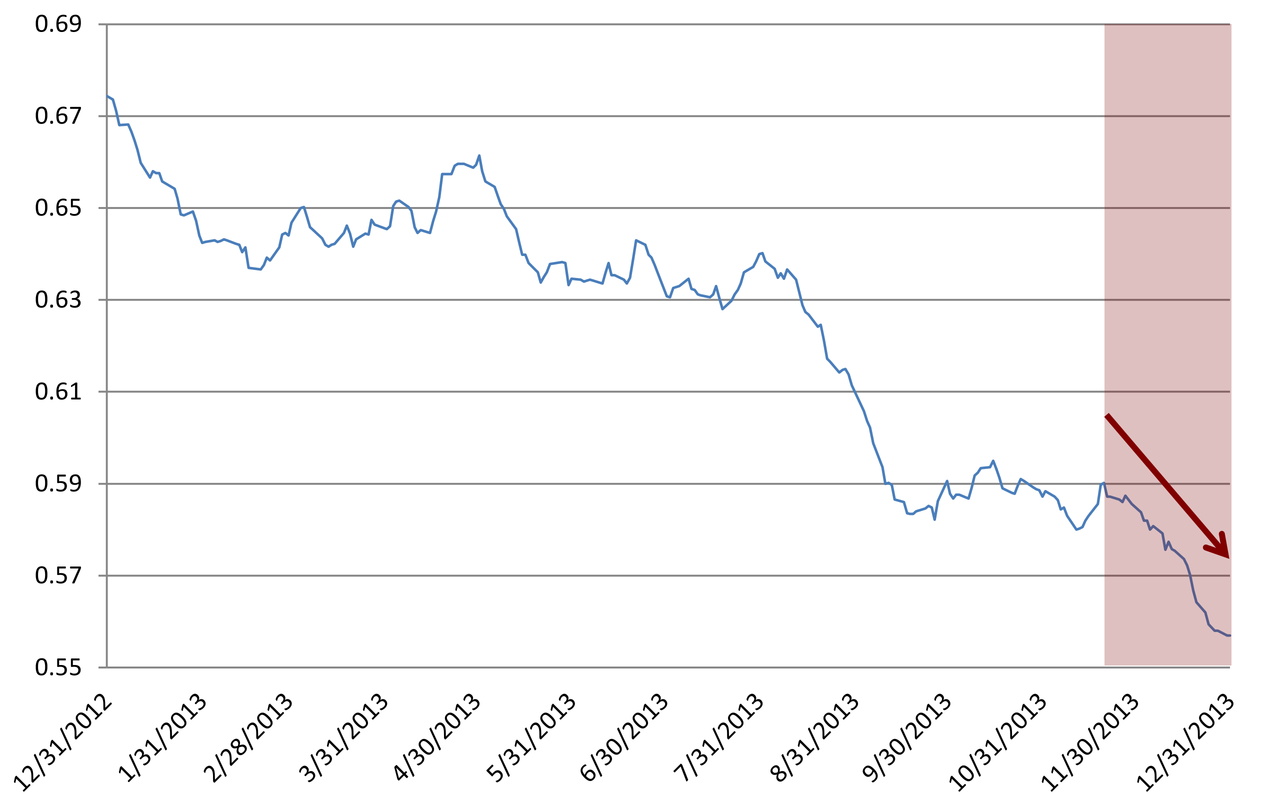
- Global crude oil prices declined in the first half of December from high November-end levels, and accelerated in the second half. Volatility, however, came down as the moves in Brent crude were slight relative to the significant price acceleration in November.

Brent Crude Oil Volatility, 12/31/12 – 12/31/13



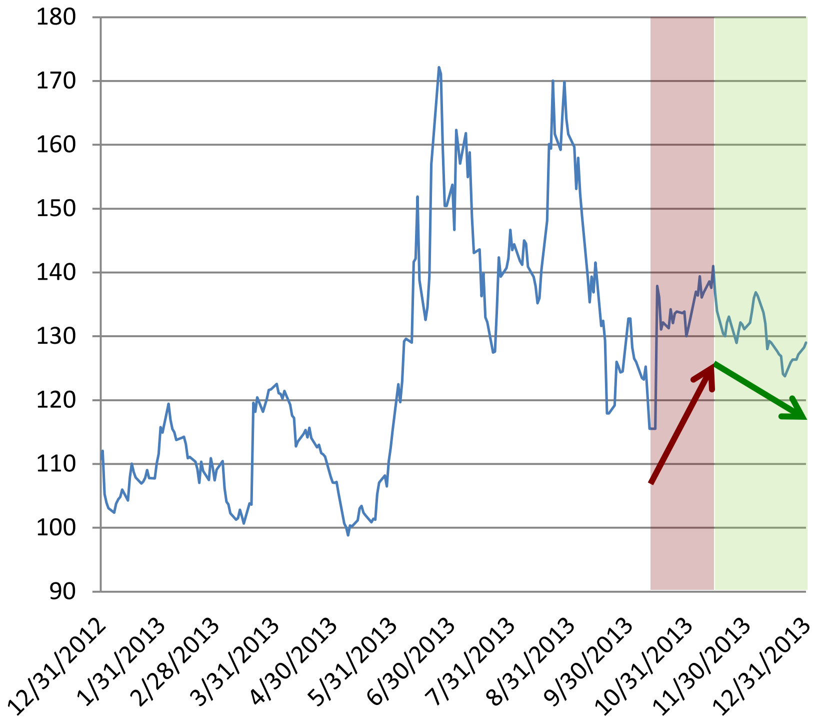
- The CBOE Equity Put/Call Ratio declined heading into and during December.
- A lower put/call ratio indicates more calls relative to puts, which is a contrarian bearish signal as the options market is historically overzealous.

CBOE Equity Put/Call Ratio, 12/31/12 – 12/31/13

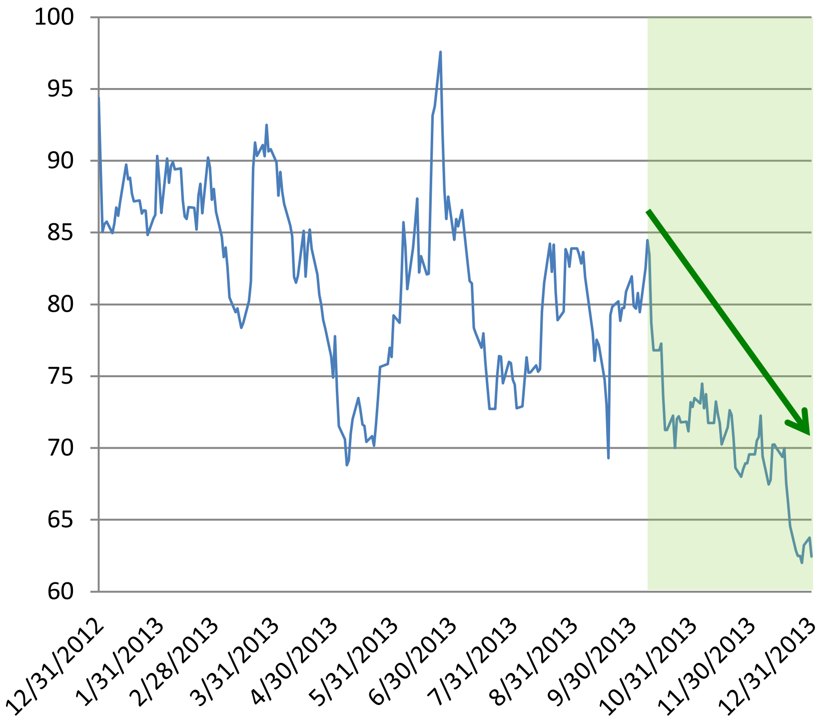


- Heading into and during December, Asian (ex-Japan) credit risk came down after spiking due to the US government shutdown. Other global credit markets extended drops in risk levels.

Asian Credit Market Risk, 12/31/12 – 12/31/13



North American Credit Market Risk, 12/31/12 – 12/31/13



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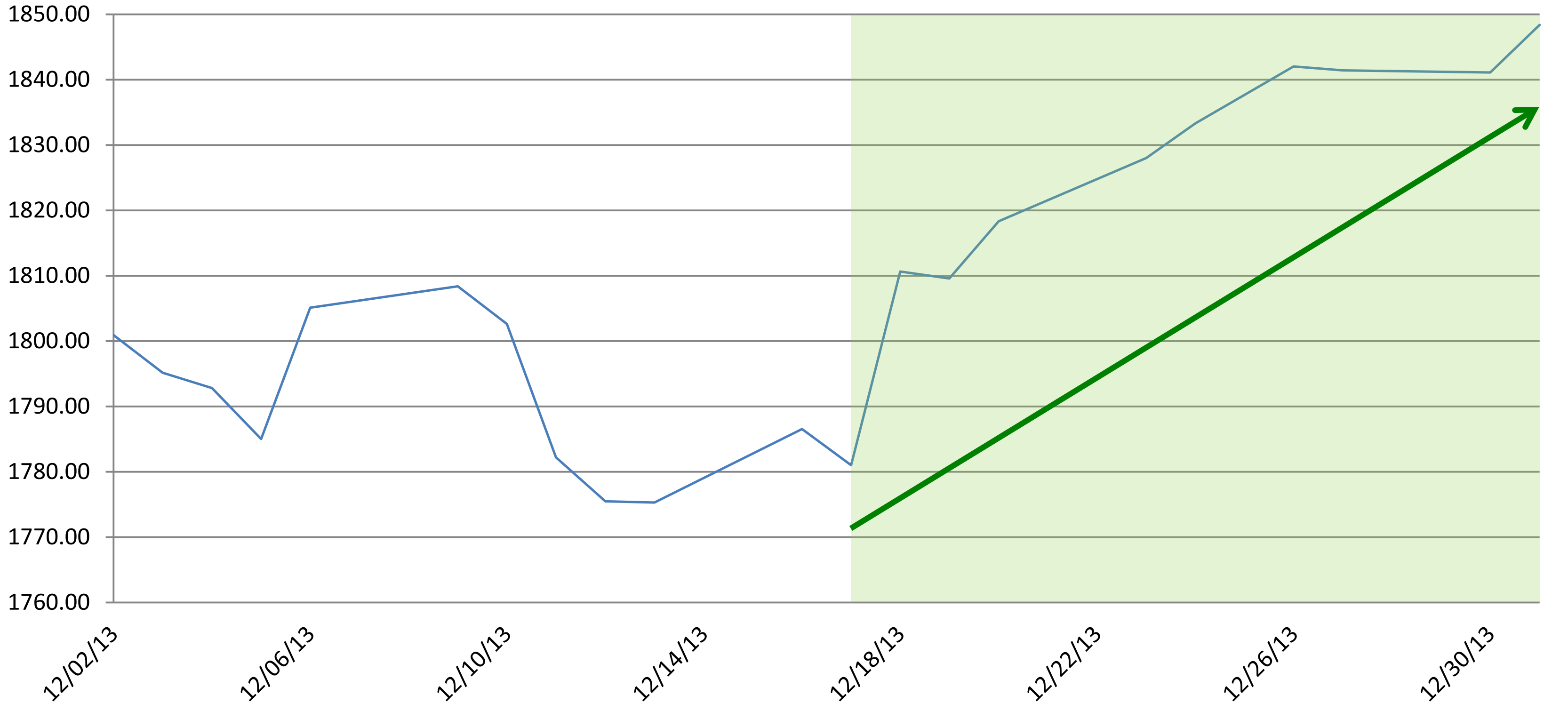
Q4 Capital Markets Review December

- The S&P 500 index appreciated over 2.5% to end the year at all-time highs levels.

S&P 500 Index, December 2013



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Global Economic Indicator Descriptions

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

The Brent Crude Oil Volatility is a measure of the movement in the price of global crude oil prices.

The North American Credit Market Risk is a measure of the cost to insure North American credit derivative instruments.

The Asian Credit Market Risk is a measure of the cost to insure Asian credit derivative instruments, excluding Japan.

The European Credit Market Risk is a measure of the cost to insure European credit derivative instruments.

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 CBOE Equity Put/Call Ratio is the ratio of puts to calls traded on the CBOE.

The Conference Board Leading Economic Index (Headline) is a composite average of several individual leading economic indicators, constructed to reveal common turning point patterns in economic data.

The Conference Board Leading Economic Index (Diffusion) is a measure of the breadth contributing to the LEI Headline Index.

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Global Economic Indicator Descriptions

The US Durable Goods Orders MoM Change is a measure of the monthly change in US orders for manufactured durable goods.

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

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

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 MoM Change In Labor Force (CPS) 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 US Retail Sales MoM Change report is an index measuring the monthly change in adjusted US retail and food service sales.

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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