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Investors Alley
Blue Chip Gems

Focus on Safety and Dividends to Start 2016

Fellow Investor,

It has not been the same start to 2016 that most pundits and prognosticators had envisioned when they made their predictions for the New Year as 2015 came to a close.

In This Issue

The S&P 500 lost eight percent in the first two weeks in trading and the NASDAQ dropped more than 10%. This was the worst two weeks of performance to start a year in the market's long history. The market did manage to post its first weekly gain last week thanks to a broad based rally Friday as crude had a big move up although it still remains down more than 10% on the year so far. Strong readings from manufacturing and housing also helped the market rally on Friday.

The stealth bear market that played havoc with the fringes of the market in 2015 such as in energy, commodities, and small cap stocks has become a full-fledged correction in 2016. In addition to those sectors mentioned above, biotechs and transports have also entered into official bear market territory. Regions including Europe, China, and Japan are also down at least 20% from previous highs.

Earnings season is upon us and it should be the third quarter in a row that profits within the S&P 500 will show a year-over-year decline. The main headwinds impacting earnings are the collapse of profit from energy producers, the strong U.S. dollar, and the anemic global economy.

I think the market needs to see three things happen for it to get past this current bout of volatility and move higher.

First, oil needs to stabilize. When the price of oil first started to fall, most commentators focused on the positives for consumers and the economy that lower oil prices will bring. Unfortunately, the drop has been so sudden and steep the negatives of collapsing crude prices continue to outweigh the positives at least in the markets' eyes. Oil producing nations throughout OPEC are pulling back on their spending budgets on a dramatic scale. Our home grown shale industry is also under tremendous pressure and the economies of two of our three largest trading partners, Canada and Mexico, are having problems. Russia is going through its reserves even as it continues to be a geopolitical thorn.

The biggest impact however is on the debt markets. Emerging market debt from energy producing nations like Brazil and Argentina continues to get downgraded. As importantly, the impacts to the high yield credit markets or junk bonds have been dramatic. Yields have spiked and just about anything in the market that has a good deal of debt on its balance sheet has been taken to the woodshed and beaten like a rented mule. This includes real estate investment trusts, some of which are down 30% to 40% despite the ten-year treasury yield falling towards two percent to begin the year. We need these credit markets to stabilize and improve for the equity markets to behave better. Fortunately, most of the Blue Chip Gems' portfolio has rock solid and in some cases fortress-worthy balance sheets. I believe if oil and other commodity prices find a bottom and start to move higher, the high-yield credit markets will start to heal.

Finally, we need to see both the economy and stock markets in China stabilize. The Middle Kingdom has become the second largest economy in the world thanks to a quarter century of robust growth. That growth has been decelerating over the past few years and is now at its lowest levels in over 25 years as the country tries to transition from a manufacturing led economy to a consumer led one. This has had severe impacts on commodity prices as China is by far the largest consumer of coal, iron, steel, copper as well as other metals and materials.

This transition is likely to continue to be painful for commodity exporters and global growth. However, it will impact Europe more than the United States as the Eurozone gets a much higher percentage of their overall GDP through trade with the Middle Kingdom than we do domestically. Commodity producing nations like Australia and Brazil will continue to be the most impacted by this development. For markets to move higher I believe investors need to believe that China's growth will stabilize and its stock markets need to quit moving up or down three to five percent on an almost daily basis which spikes volatility throughout the global markets.

I think until we see these three key indicators stabilize, the volatility we have seen to start to 2016 will continue to be higher than we have experienced in some time. When they quit being the focus of the market I think stocks will be able to move higher.

If you ever have a question or comment you can reach me at bret.jensen@investorsalley.com.

Thank you and Happy Hunting.

Bret Jensen
Editor
Bret Jensen's Blue Chip Gems

P.S. The returns in my other newsletter *Biotech Gems* have been on a tear recently with one position already up 120%. With 19 more recommendations in one of the hottest sectors of the market we are well on our way to building a complete biotech portfolio that should trounce the market for years to come.

In fact, I am giving away three of my favorite tickers in the sector for free right now, just click here.

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Wells Fargo: Better Positioned than Bank of America

This month, we will be swapping out our position we currently hold in **Bank of America (NYSE: BAC)** for a new position in **Wells Fargo (NYSE: WAC).** There are myriad reasons for doing so at the current moment in my opinion.

To say the least, the start of the year has not started out as most investors in financials had hoped it would. The sector was a favorite of many fund managers to begin 2016 for numerous reasons. The Federal Reserve had just raised rates for the first time since 2006 in mid-December. The central bank had also guided that it expected to raise rates four more times in the New Year by a quarter point. This led to hope for a much improved environment for banks. Rising interest rates mean bigger net interest margins for banks which equate to better bottom line results. Bank of America provided estimates that each one percent hike in their net interest margin would result in more than $1 billion in additional profits every quarter.

Unfortunately, thanks to a “flight to quality” triggered by the spike in volatility throughout the global markets, the yield on the ten-year treasury has actually declined since the Fed’s interest rate hike and hovers just above the two percent level currently. Once oil, commodities, and China stabilize I do still believe the trend of interest rates will be up in 2016 but so far that hoped for event is delayed.

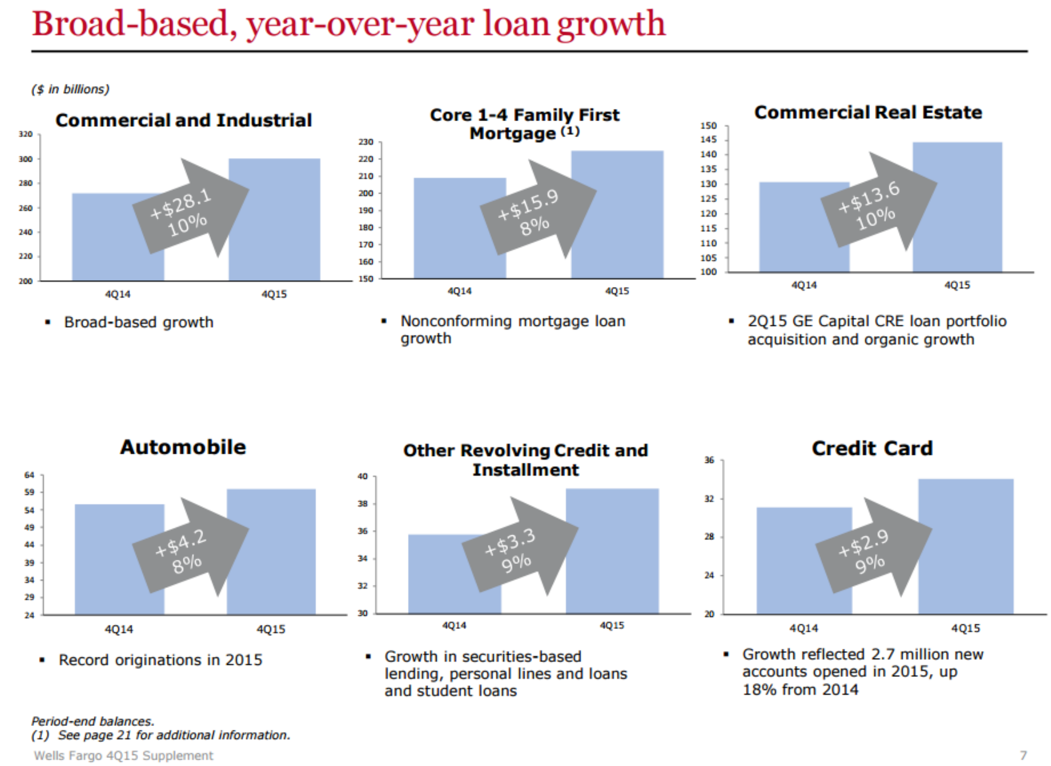
The other factors that should buoy major banks are still in place. Credit quality remains strong, job growth is still solid, and the economy is still muddling along at around two percent GDP growth levels. In addition, the worse of litigation and regulatory costs do appear behind the financial industry and the sector could even be aided by a change in political leadership later this year.

There have been some concerns that the collapse of oil prices and the subsequent volatility in the high yield credit markets or “junk bond” space may impact major banks’ balance sheets. However, energy loans make up a pittance (about 2%) of overall bank loan portfolios. I would be more worried about a lot of hedge funds that got into high yield energy debt early in 2015 and are sitting on large unrealized losses. In addition, capital ratios at major banks are much better than they were prior to the financial crisis and the energy sector is much, much smaller than was the mortgage market prior to the 2008 debacle.

So why are switching horses mid-stream? There are several core reasons why I believe it behooves us to trade in one of the four major banks for another at the present time.

Simplicity:

M&A transactions hit record highs last year by dollar volume as some $4.7 trillion worth of deals were announced. The stock and credit markets were stable as well especially compared to the volatility both have seen to open 2016. These were good things for Bank of America due to its large presence in these arenas via its Merrill Lynch arm.



However, conditions in the markets have obviously changed and not for the better. If this turmoil continues, M&A volumes can be expected to drop significantly. New equity and debt offerings are also already seeing a substantial slowdown from the previous year's levels. The high yield or "junk bond" market has witnessed a huge spike in yield and volatility. More and more investors are worried about myriad small and midcap energy and mining concerns that could be on their way to bankruptcy given the continued collapse in energy and commodity prices.

I think is prudent to switch to a more "vanilla" financial institution which less moving parts. Wells Fargo has a very limited presence in the markets Merrill Lynch operates. However, it is the nation's largest private mortgage lender. Given I expect the housing market to continue its slow and steady improvement thanks to solid job growth, historical low mortgage rates, and years of pent up demand, this is a good thing.

Safety:

Simplicity is one part of safety which I think is a trait that should be emphasized within one's portfolio in turbulent times like these. Dividends are another aspect of safety and tend to help put a floor under any decline in the market. Wells Fargo pays a dividend north of three percent at current prices, Bank of America currently pays about half of that. While it is true that Bank of America can be counted on in all likelihood to raise its dividend payout much faster in coming years as it puts the aftermath of the financial crisis behind it, right now I think it is wiser to have a bird in the hand rather than two in the bush.

In addition, Wells Fargo's results over the past year or so have been much less "lumpy" than those of Bank of America and it rarely disappoints compared with expectations. Finally, I agree with Goldman Sach's recent comments as it upgraded its view on Wells Fargo. Goldman believes Wells Fargo to be the best positioned major bank to "face the least downside this year if oil prices slip, China slows, and rates stay flat. It also has potential upside from its GE Capital purchases."

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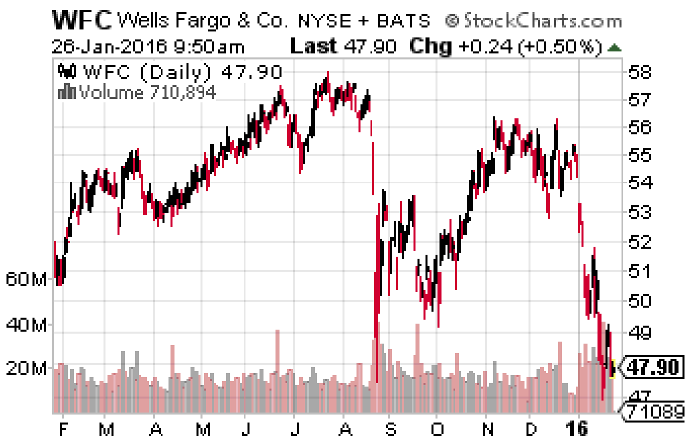

Of the major banks, Wells has the least exposure to overseas factors that have rocked the market so far in 2016.

Management:

I also think Wells management team is better structured for the current environment we suddenly find ourselves in due to spike in global concerns. Bank of America's management team is well positioned to put the regulatory and litigation challenges it faced after the financial crisis behind it as it is led by its former chief counsel. The management team at Wells remains intact and went through the financial crisis better than any large financial institution other than **JP Morgan (NYSE: JPM)**. Now is the time to have seasoned hands on tiller as we once again look like we will have to navigate through some choppy seas although I don't think it will be anywhere near as bad as 2008. The current environment feels more like the hiccup the markets experienced in 2011 when all eyes were riveted on Greece and the other sovereign debt concerns in the periphery of Europe. Once we get past this bout of volatility, the environment for banks should again be supportive.

Valuation and Outlook:

Wells Fargo currently is priced at just under $48.00 a share. Thanks to the recent turmoil in the markets, the shares are down some 15% from where they began the New Year. In coming years, earnings should increase five to 10% on an annual basis and I would expect dividends to be hiked in accordance with that growth. Obviously, the faster the domestic economy grows, the better earnings will grow too. Wells is a solid long-term bargain here at approximately 11 times forward earnings with better than a three percent yield. Barclays and FBR Capital have both reiterated Buy ratings and $63.00 a share price targets over the past week or so. Once the current global clouds on the market recede, that sounds like a reasonable yearend target for Wells Fargo.

Recommendation: Buy WFC up to $51.00 a share.

Position: Long WFC

Portfolio Update

It has been a rocky market since our last portfolio update. Equities got off to their worst two-week opening to begin a year in the stock market's history before posting their first weekly gain in a month last week. Although it was a slight rise, it was most welcome by investors especially given at one point last Wednesday the Dow was down some 550 points intraday.

Nothing has quite worked out the way most pundits had predicted to open the New Year. Most were sanguine about the Federal Reserve's first rate hike since 2006 in mid-December. Some of the same prognosticators are now already calling the slight bump off of zero a "policy mistake" given it preceded a huge spike of volatility across global markets.

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Surprisingly, the rate hike actually has led to lower yields on the ten-year treasury. Financials, which most had as a sector to overweight to begin the year partly as a result of higher interest rates have fallen instead. This despite most of the major financial institutions reporting better than expected quarterly numbers. There also seems to be concerns about the impact of souring energy loans on banks' balance sheets. These worries seem unwarranted given energy loans make up some two percent of major banks overall loan portfolios.

Both **Capital One (NYSE: COF)** and **JP Morgan (NYSE: JPM)** are down significantly over the past month despite earnings results that beat expectations on both the top and the bottom line. **Blackstone (NYSE: BX)** and **Bank of America (NYSE: BAC)** also fell over the last month. I still believe interest rates will rise from here and valuations in the sector are cheap so we are maintaining our weighting in the sector. However, we are swapping out our position in Bank of America for one in **Wells Fargo (NYSE: WFC)** as the latter is better positioned to navigate the current environment.

As of this issue, Bank of America will no longer be followed in the Blue Chip Gems portfolio. It will now be found under "Closed Positions."

Even mighty **Apple (NASDAQ: AAPL)** had a rough month as did most of tech. Apple looks like it is cutting demand forecasts for the iPhone a bit but looks incredibly cheap at eight times forward earnings if you take out its cash hoard. The stock also appears to be bottoming and crossed back over the $100.00 a share level in the rally on Friday. Look for a dividend hike in the near future and of course the anticipation of a new version of the iPhone sometime later in summer.

Macy's (NYSE: M) was a standout performer this month despite the dismal backdrop for stocks. Its four percent

dividend yield, activist pressure, and vast real estate holdings finally put a brake on its recent decline and it posted a nice gain for the month. Colder weather including the mega-blizzard in the northeast should help its winter apparel sales in the first quarter. Our other retail pick **Foot Locker (NYSE: FL)** also held up very well during the carnage in equities to begin the New Year.

Our biotech selections like **Amgen (NASDAQ: AMGN), Celgene (NASDAQ: CELG) and Gilead Science (NASDAQ: GILD)** fell pretty much in line with the major indices but could start to rally if quarterly earnings come in strong beginning this week. The only real disappointment in our healthcare picks was **Express Scripts (NASDAQ: ESRX)** which took a hit this month as **Anthem (NASDAQ: ANTM)** demanded $3 billion a year in additional drug savings. This seems like an opening gambit on contract negotiations and think the shares will bounce back when some sort of compromise is made between the two parties.

That summarizes what has been a rocky start for the markets and global economy to start 2016. I believe if oil and China stabilize in the months ahead, we will start to see an improving environment be reflected in our portfolio. In the meantime, I am happy to collect the nice dividend yield provided by a decent portion of our holdings and expect solid results as we get into the meat of fourth quarter earnings season.

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Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Yield	Returns	S&P 500 Comp.
Wells Fargo (WFC)	01/25/16	$47.66	$47.66	3.1%	N/A	N/A
Alphabet (GOOGL)	12/28/15	$782.24	$733.62	-	-6.2%	-8.7%
Macy's (M)	11/24/15	$39.63	$39.32	3.5%	-0.8%	-10.2%
Merck (MRK)	10/27/15	$53.47	$50.92	3.6%	-4.8%	-9.1%
Allergan (AGN)	09/29/15	$254.87	$295.95	-	16.1%	-0.4%
Amgen (AMGN)	08/28/15	$155.89	$153.43	2.6%	-1.6%	-5.6%
Celgene Corp. (CELG)	06/26/15	$117.92	$106.70	-	-9.5%	-10.7%
Blackstone Group (BX)	05/18/15	$43.64	$25.03	7.5%	-42.6%	-11.8%
Qualcomm (QCOM)	04/15/15	$68.46	$47.58	4.0%	-30.5%	-10.9%
Capital One (COF)	04/15/15	$82.82	$58.66	2.6%	-29.2%	-10.9%
Express Scripts (ESRX)	03/18/15	$83.29	$72.31	-	-13.2%	-10.6%
Foot Locker (FL)	03/18/15	$61.17	$64.47	1.5%	5.4%	-10.6%
AbbVie (ABBV)	02/13/15	$58.05	$58.65	3.9%	1.0%	-10.5%
Valero Energy (VLO)	02/13/15	$58.60	$65.14	3.5%	11.2%	-10.5%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$90.61	1.9%	-10.0%	-7.0%
Apple Inc. (AAPL)	01/16/15	$105.99	$99.44	2.1%	-6.2%	-7.0%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$55.66	3.1%	-0.5%	-7.0%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$39.11	6.7%	-28.7%	-7.0%

Recent Price is updated from stock closings on 01/25/16

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Closed Positions

Company	Entry Date	Entry Price	Close Price	Returns	Close Date
Micron Technologies (MU)	1/16/15	$28.99	$14.19	-51.1%	12/28/15
Bank of America (BAC)	07/28/15	$17.88	$12.96	-27.5%	01/15/16

Notes:

Entry price is determined by the last "Close" price at the closing of the market on the day before publication. Recent price is determined by the last "Close" price at the closing of the market on the day before publication; most recent update: 01/25/16. Returns is share price appreciation or depreciation between entry price and recent price. S&P Comp. represents the returns on the S&P 500 Index from the point of entry of a stock listed above through the recent price and is meant to provide a comparison to the overall small cap stock market as comprises that index.

This is not real-time data and should not be interpreted as such.