Investors Alley
Blue Chip Gems

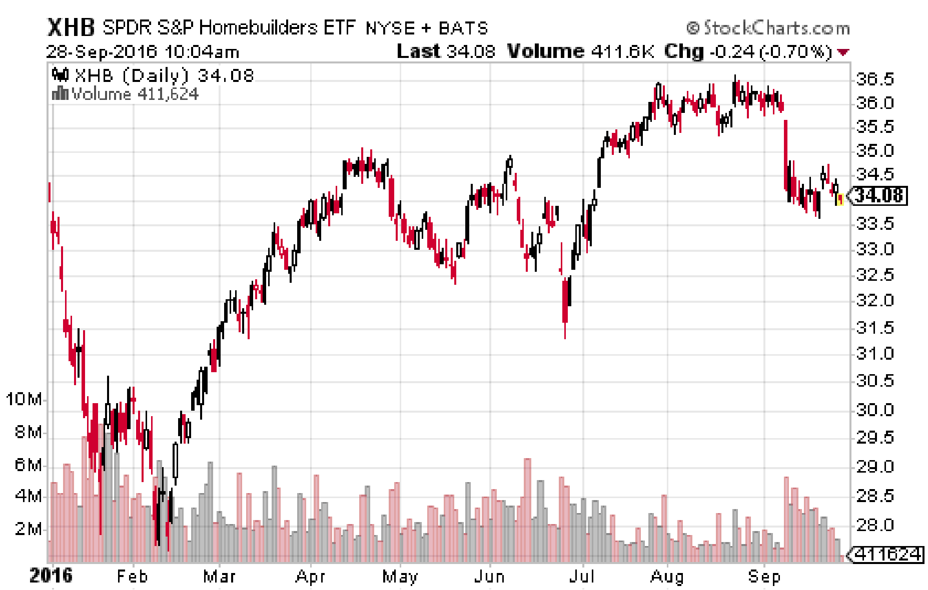
Continued Low Rates Make this Stock a Buy

The market has continued to slowly grind up in September as the third quarter and the summer rapidly comes to a close. The worries that the Federal Reserve would raise interest rates at their meeting last week that caused equities to sell-off some three percent on September 9th proved to be overblown as the central bank once again kicked the can down the road and past the upcoming presidential election as I expected. At this point, the central bank is starting to remind me of the character Wimpy "I will gladly pay you Tuesday for a hamburger today" from Popeye's fame.

In This Issue

Oil remains in a relatively tight trading range of between $40 and $50 a barrel as it has been for several months. Some of the larger members of OPEC continue to make noises about agreeing to a production freeze as the drop in crude continues to squeeze national budgets. However, with worldwide economic activity at levels not seen since 2009 and American shale producers now the global "swing" producer, I don't see any spike in oil in the medium term.

I continue to believe that housing will advance going forward in a two step forward/one step back fashion as it has throughout this year. Mortgage rates remain near historical lows, job growth is solid but not spectacular and housing starts are still way below their averages of the past 40 years. In addition, both presidential candidates will want a strengthening housing sector given it is a huge job creator. Finally, household formation is back



XHB is the 'Homebuilders' ETF. You can see the two steps forward one step back movement of this year.

above pre-financial crisis levels, which, combined with a decade of way below average housing starts, should mean years of pent up demand. Ironically, one of the biggest inhibitors to greater home sales is a lack of inventory right now.

The market has done pretty well in 2016 given the horrid start equities had in the first five weeks of the year. This is especially true as we have only had domestic growth of one percent over the past three quarters. Economic activity is currently projected to pick up significantly and post 2.5% GDP growth in the final two quarters of the year. This will be a welcome tailwind to corporate earnings as the S&P 500 has been in a “profit recession” for five straight quarters now.

One of the few areas of the market that is delivering consistent earnings and revenue growth are the large pharma and biotech firms. They had a difficult first half of the year thanks partly to election driven rhetoric around drug price “gouging” as well as an actual bad actor or two. However, sentiment has markedly increased in the third quarter. If the election results in a continued divided government as I suspect, I expect these will be strong performers after election day and through the end of year.

Happy Hunting

Bret Jensen

Editor, Blue Chip Gems

P.S. Finding biotech stocks with upcoming catalysts for explosive growth is a key component of my comprehensive strategy for massive profits in my newsletter, Biotech Gems.

And while I spend hours researching biotech stocks every week, I select only those meeting my stringent 6-point criteria developed over my decades-long successful biotech investing career.

Right now, you can gain immediate access to 20 stocks… stocks with the potential for immediate double – even triple-digit gains.

Our latest addition to the portfolio has a huge catalyst right around the corner (2 weeks to be exact) that could send its stock price skyrocketing, so don’t delay.

Click here to find out more.

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Toll Brothers, A Solid Bet on an Improving Housing Market

Once again the Federal Reserve chose to talk a tough game about potentially raising interest rates by a quarter point at their meeting in September. Once again the central bank punted, albeit with three dissents among the voting members of the panel this time. It is looking at most we will get one quarter point hike in December after the election. This is a far cry from the three to four quarter point hikes both pundits and the Federal Reserve projected for 2016 towards the end of last year.

The fact is that the Federal Reserve has painted itself in a corner. In hindsight, the central bank should have raised rates in 2014 when the domestic and global economic growth were stronger and before its brethren central banks in Japan and Europe began pursuing negative interest rate policies. Now its choices are limited as a series of hikes will strengthen the dollar beyond acceptable levels and quite possibly put an anemic domestic economy into a recession.

Its only course of action is perhaps a quarter point hike coupled with a lot of "jawboning" to assure the market that the central bank not only still has options, but that it is maintaining its vigilance against inflation and complacency. This reinforces my outlook that the historically low interest rate environment that investors have had to navigate for several years will remain firmly locked into place over at least the next year or two.

While bad for certain parts of the market like banks and insurers, low interest rates ensure a favorable environment will remain in place for sectors of the economy like housing. This part of the economy has seen choppy but consistent growth in recent years. Housing starts came in at the highest levels since 2007 in 2015, and 2016 is on track beat last year's levels.

Despite the improved level of housing starts in recent years, the country has seen a decade of housing start levels substantially under the average of the past forty years. With historically low mortgage rates, a solid job market, and household formation and population significantly above pre-financial crisis levels, there should be years of pent-up demand that needs to be met in this area of the economy.

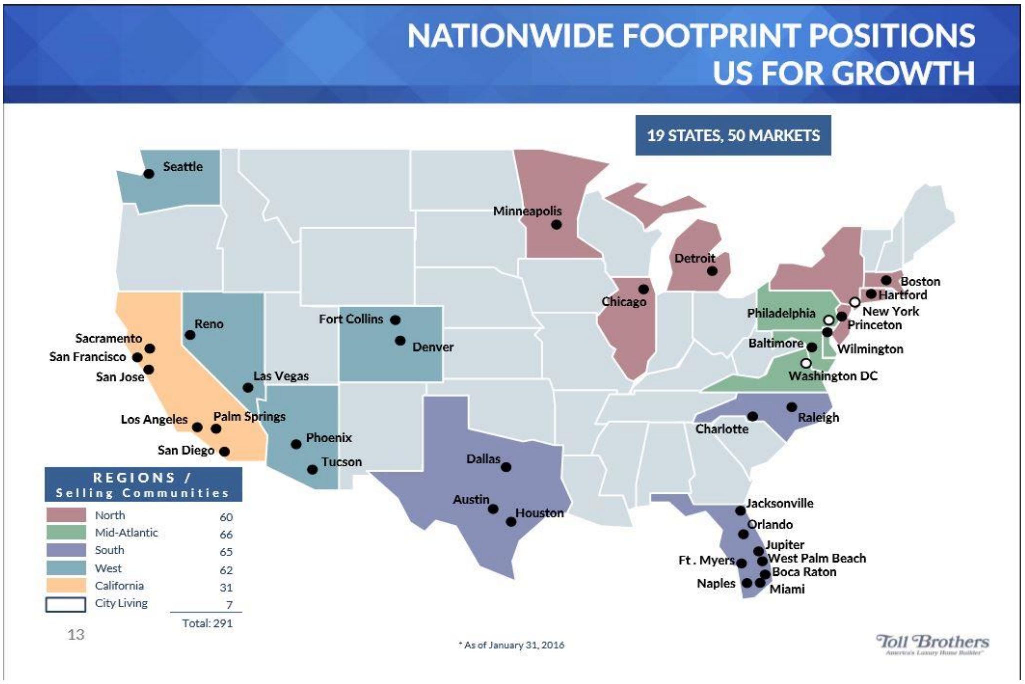
In addition, whoever becomes president will want a stronger housing market given the industry is a large job creator. This means it is time to add another large, well-run homebuilder to the Blue Chip Gems portfolio.

Company Overview:

Toll Brothers (NYSE: TOL) is the nation's leading upscale homebuilder. The company was founded in 1967 and came public three decades ago. The company builds in 50 markets across 19 states and is well represented in the Western, Eastern, and Southern parts of the country. It serves the high-end of the market where the majority of the income growth has been over the past decade with an average home selling price of just over $800,000. The school district rating of its communities are the highest of any builder which is a key to attracting a good portion of the affluent base. The stock currently trades at approximately $29 a share and sports a market capitalization of just $5 billion. The shares are off some 25% currently from their 52-week highs.

The Current Housing Market:

The housing market continues to moves forward in a two steps forward/one step back fashion which it has consistentlydone over the past couple of years. Just recently, housing starts were weak in August while



homebuilder confidence far exceeded expectations and were at their highest levels in a year. New home sales in July also flew past the consensus. June posted the highest new sales of existing homes in eight years. Ironically, one of the key drivers holding back new home sales currently is a lack of inventory to sell.

In addition, a lot of cities have dramatically increased development fees per lot since the recession to patch up their finances. These fees in some places have gone from $3,000 to $5,000 per lot to $15,000 to $25,000 per lot. Ironically, politicians consistently gripe about the lack of “affordable housing” even as governmental policies at the local level are a contributor to the lack of supply in this area. At the high end, such as the homes Toll builds, this has less effect on margins. Although there is a lot of “noise” in the monthly indicators, there is little doubt that the overall trajectory is up for the housing market.

Recent Results:

In its last released quarter, the company reported earnings of 61 cents a share which was in line with the consensus. This was a big increase from the 36 cents a share the company reported in the same period a year ago. Revenues rose more than 23% on a year-over-year basis and came in some $20 million above the consensus.

The company did trim forward earnings and margin guidance slightly. However, growth prospects look more than solid. Signed contracts rose some 18% Y/Y during the quarter and order unit backlog grew 19%.

Balance Sheet and Risk Management:

The company is very prudent and has a solid balance sheet as well as $1.3 billion in available credit. Its debt maturities are staggered and its customers have strong credit profiles as well. 22% of its homes bought in 2015 were paid fully in cash. Their buyers have strong credit profiles with an average FY 2015 FICO score of 756 on conforming loans and jumbo loans. This is important as its mortgage subsidiary serves 57% of the customers that used mortgage loans to purchase Toll properties. The Average LTV was 70% in FY2015. The mortgage unit pre-sells loans individually to minimize risk.

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This is a key reason the average amount spent on upgrades per home with Toll Brothers is currently $134,000. The company has also diversified into high end rental apartments, new buildings in high end urban centers such as New York City and some campus properties in recent years. Most importantly, the company has not gone crazy accumulating lots in anticipation of unrealistic future demand. As can be seen below, even with the uptick in demand over the past few years; the company's lot inventory is about half of what it was at the height of the last market.

Growth, Valuation, and Outlook:

The company made just under $2.00 a share in FY2015. Toll Brothers is tracking to right around $2.50 a share in profit in FY2016 and the current consensus calls for just over $3.00 a share in the black in FY2017. This means the shares currently fetch less than 10 times forward earnings despite solid double digit growth prospects as the housing market continues to improve over the next few years. Compare this with the S&P 500 which sells for 17 to 18 forward earnings and this might be optimistic given the third quarter will likely be the sixth one in a row that profits within the S&P 500 have declined on a year-over-year basis.

I believe as investors become more confident in the quarters ahead that the housing market is durable it will reprice Toll in the range of 12-14 times forward earnings which should us get us to approximately $40 a share, which is right at 52-week highs.

Recommendation: BUY TOL up to $31 a share.

Position: Long TOL

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Portfolio Update

The market has moved up ever so slightly since our last update as the Federal Reserve decided to not move on interest rates at its September meeting that recently concluded. Its decision did have three "dissents", a very high number. Investors should expect the central bank will finally hike rates by a quarter point at its next meeting in December safely after the election.

However, given the anemic state of the global economy as well as the European and Japanese central banks pursuing negative interest rate policies, it is hard to see this being the first of a series of hikes and is more likely to be a "one and done" scenario and low rates will exist through 2017 at least. This removes a possible positive scenario for banks who would benefit from higher net interest margins so they will remain challenged in 2017 regardless of which presidential candidate triumphs in November. Combined with its own recent descent of becoming politicians' recent favorite whipping boy, this is why **Wells Fargo (NYSE: WFC)** is being removed from the portfolio in this month's edition of Blue Chip Gems. In its steed we will add a company that should benefit from the current low interest environment for at least the next year or two.

On a much brighter note, **Apple (NASDAQ: AAPL)** has rebounded nicely lately and actually had its best one week of performance in several years in September after initial demand figures for its recently launched iPhone 7 posted much stronger than anticipated numbers. The company is also benefiting from the much publicized recent problems around batteries from its main rival, Samsung.

Our other tech stocks, **Alphabet (NASDAQ: GOOGL)** and **Qualcomm (NASDAQ: QCOM)** are basically flat since our last update as it most of the portfolio. The former could possibly benefit from recent questions around the effectiveness of **Facebook's (NYSE: FB)** video ads even as it staves off a politically driven European regulatory and tax assault, something that Apple has also had to deal with recently. If one ever wonders why Europe has no Silicon Valley, look no further.

Las Vegas Sands (NYSE: LVS) continues to follow up on its recent strong performance. Traffic is finally starting to revive in Macau and its 3,000 room Parisian Macao open there with much fanfare and strong reviews this month. Traffic in Las Vegas, its namesake although most of its revenues comes from Asia these days; also has picked up in recent months. With a five percent dividend and capital expenditure needs dropping dramatically over the next couple of years after its Macau resort is now opened, I continue to like the name.

Our large pharma and biotech picks went nowhere this month but I expect them to get a nice post-election bounce if the vote results in a continued division of government. I believe this is the most likely outcome and will take any major legislative changes that could negatively impact the industries off the table.

And that is how I see the market as we head into the last few days of the third quarter.

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Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Yield	Returns	S&P 500 Comp.
Toll Brothers (TOL)	09/27/16	$29.30	$29.30	-	N/A	N/A
Lennar (LEN)	07/28/2016	$48.28	$42.72	0.4%	-11.5%	-.05%
Signet Jewelers Ltd. (SIG)	6/29/2016	$82.00	$74.69	1.3%	-8.9%	4.8%
Pfizer (PFE)	05/27/16	$34.61	$33.83	3.5%	-2.3%	3.4%
Allergan (AGN)	04/18/16	$219.91	$239.36	-	6.1%	3.6%
Teva Pharmaceuticals (TEVA)	03/28/16	$53.85	$49.47	2.6%	-8.2%	6.5%
Synchrony Financial (SYF)	02/25/16	$27.78	$27.81	1.9%	0.1%	11.2%
Alphabet (GOOGL)	12/28/15	$782.24	$810.73	-	3.6%	5.5%
Macy's (M)	11/24/15	$39.63	$36.60	4.1%	-7.6%	3.9%
Amgen (AMGN)	08/28/15	$155.89	$171.63	2.3%	10.1%	9.1%
Celgene Corp. (CELG)	06/26/15	$117.92	$107.40	-	-8.9%	3.3%
Qualcomm (QCOM)	04/15/15	$68.46	$63.31	3.4%	-7.5%	3.0%
Capital One (COF)	04/15/15	$82.82	$71.80	2.2%	-13.3%	3.0%
Foot Locker (FL)	03/18/15	$61.17	$68.08	1.6%	11.3%	3.4%
AbbVie (ABBV)	02/13/15	$58.05	$64.57	3.5%	11.2%	3.5%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$79.25	2.3%	-21.3%	7.5%
Apple Inc. (AAPL)	01/16/15	$105.99	$113.09	2.0%	6.7%	7.5%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$56.89	5.0%	3.6%	7.5%

Recent Price is updated from stock closings on 09/27/16

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Closed Positions

Company	Entry Date	Entry Price	Close Price	Returns	Close Date
Wells Fargo (WFC)	01/25/16	$47.66	$45.09	-5.4%	09/27/16
Merck (MRK)	07/28/16	$53.47	$58.43	9.3%	07/28/16
Blackstone Group (BX)	05/18/15	$43.64	$24.75	-43.3%	06/29/16
JP Morgan (JPM)	01/16/15	$55.93	$65.43	17.0%	05/27/16
Valero Energy (VLO)	02/13/15	$58.60	$60.71	3.6%	04/18/16
Express Scripts (ESRX)	03/18/15	$83.29	$67.67	-18.8%	03/28/16
Allergan (AGN)	09/29/15	$254.87	$296.34	16.3%	02/25/16
Bank of America (BAC)	07/28/15	$17.88	$12.96	-27.5%	01/15/16
Micron Technologies (MU)	1/16/15	$28.99	$14.19	-51.1%	12/28/15

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: 07/28/16. 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.