Stocks' Rocky 2016 Start Yields Blue Chip Bargains: Scoop 'em Up!

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2016 has been a big disappointment for stock investors. Despite hopes the bull market would continue into an eighth year, this January ravaged confidence. The S&P ended the month down 5%, the worst start to a year since 2009!

A cratering crude price spooked many, falling 18% in January, following December's 15% dive. While historically it's been oil spikes that cracked economies, the near 75% plunge in prices over a two year period was treated not as a tail wind, but a barometer on the health of the global economy.

A tone deaf Federal Reserve also weighed. In December, our central bank hiked rates for the first time in nine years; its accompanying forecast suggesting as many as four more boosts in 2016 was quickly met with derision. Weakening conditions overseas, a lack of inflation here, and speculation about a US recession had commentators publicly debating the likelihood of the Fed reversing course and announcing negative interest rates.

Markets Rebound Mid February

However, there are now plenty of reasons for a constructive take on the outlook. With the markets down 10% in early February, investor sentiment turned bullish. The all-important crude price soared 45% in four weeks, leading a charge back into risk assets including stocks.

Concerns about a US recession receded as labor market strength continued amid generally constructive data points on the US economy. Global markets were heartened by continued efforts by central banks worldwide to do what it takes to offset deflation. The European Central Bank expanded its debt buy back plans, lowered its key benchmark lending rate to 40 basis points below zero, and expanded the class of debt it would purchase to include corporate bonds.

The IEA (International Energy Agency) upgraded its view on the direction of crude oil prices, opining that fossil fuel prices may have bottomed out. It cited supply disruptions in Nigeria and Iraq, increasing likelihood that producers could maintain a production freeze, and reduced production in the Americas.

Low interest rates continue to provide a tail wind. With the ten year Treasury yielding over 30 basis points less than the S&P 500, yield starved investors are embracing stocks. Stocks' payout typically rises 5 to 6% annually, making for a strong likelihood of a superior total return versus fixed income over a reasonable period of time.

Near Term Risks Still Abound

With nearly 30% of economies around the world now subject to negative interest rates, skeptics scoff that the ever lower rates are having decreasing stimulative effect, with serious negative collateral consequences. However, on balance the problems of super low interest rates seem to pale compared to excessively high interest rates, particularly in a deflationary world.

Stock valuations are certainly no bargain, with the S&P generally trading at 17 times projected '16 earnings, not historically cheap. Yet, it's difficult to call a market overpriced with such a large yield advantage over the 10 year Treasury. Admittedly, that yield advantage disappears when compared to the relatively elevated yield of corporate bonds; the Dow Jones Corporate Bond Index yields 3.2%, a 1% premium to the S&P 500's 2.3%.

The earnings recession continues, meaning negative year over year profit growth. Stock price growth is dependent on earnings growth. However, some of the key profit headwinds, like low energy prices and a strong Dollar, show signs of abating.

Fish in These Sectors

The 2016 volatility has created several attractive sectors. **Financials** are down nearly 10% amid recession fears, talk of negative yields compressing margins, and possible defaults among energy borrowers. However, this has produced even more attractive valuations in a group that never truly recovered from the subprime meltdown. The fundamental outlook will improve with a strengthening economy and potentially rising interest rates.

Industrials, classic cyclical plays, offer good value after being sold off last year on the back of a strong Dollar making US made goods less competitive, global recession fears, and declining orders from energy related companies. However, generally low energy prices reduce costs, providing a tailwind for profitability.

The handwringing continues over **energy** concerns. Is slowing global growth crimping demand, leading to ultra-low prices? Or is supply glut the culprit, as new drilling technologies in the West, coupled with new supply from Libya and Iran, depress prices?

While it's probably a little bit of both, we do know that the best cure for low prices is low prices, as supply is curtailed quickly under the unprofitable conditions. Indeed, we have seen drilling down by over 50% in North America, while the second straight year of reduced capital expenditures, not seen before in modern times, lays the groundwork for firmer prices.

Energy investors' investment risk is reduced by the low share prices now prevailing, now off 30% or more from recent highs.

Blue Chips on Sale

American Express (AXP) is riding an inexorable trend of increased electronic payments. Who uses cash anymore? Its entrenched network effect gives them a wide moat around the business. What restaurant or airline won't accept "The Card"? But the real bonus asset is their horde of data on the spending/usage/lifestyle habits of millions of the globe's best heeled consumers.

This iconic American brand trades at less than 7x free cash flow, growing dividends at a near 11% annual rate, buying back shares at approximate 4-5% annual rate, with a 27% return on equity in latest quarter. Take advantage of the current 30% discount from its all-time high, and 14% mark down just this year.

Worried about a recession? American Express managed to post a profit in each of the past 10 years, right on through the subprime debacle.

The premier aviation specialist, America's largest exporter, **Boeing (BA)** is riding a secular boom in air travel, up 5% annually, and that may well accelerate. Air travel is becoming ubiquitous, as the world becomes smaller and ticket prices lag inflation. Lower fuel costs do not hurt the bullish outlook.

Boeing is also one of America's premier defense contractors, with nearly half of that business awarded without competitive bidding, underscoring its unmatched expertise. There's a greater appetite for defense spending, as deficits improve and both sides of the "political aisle" heighten their focus on geopolitical risks.

Again, worried about slowing global growth? Boeing has great earnings visibility with its order backlog of 5800 aircraft. A slowdown in capital expenditures is allowing rapid dividend increases and stock buybacks.

This year's rocky start has created a timely entry into the stock: The 12% fall year to date provides a very attractive yield, indeed 3.5%, approaching twice the yield on the 10 year Treasury. That dividend has increased 14% annually on average over last 10 years.

To take advantage of a belief that fossil fuel prices will be higher, much higher, over time, consider **Chevron (CVX)**. Even a sideways market can work. Chevron's geographical reach and diversification into refining and chemicals can help mitigate weaker revenue growth, allowing it to take share from the weaker. Its capital expenditures annually exceed many smaller outfits, giving it tremendous cost cutting opportunities and staying power until the next energy bull market.

While you wait, enjoy the 4.5%+ dividend yield, with a stock price less than 9 times cash flow and just 1.3 times revenue. That dividend is nearly 15 times what an investor will receive in a German 10 year bond, and more than twice the US 10 year Treasury. That dividend has more than doubled over the last decade.

Thanks this year’s bumpy start for financial markets for producing a host of blue chips selling at bargain levels.