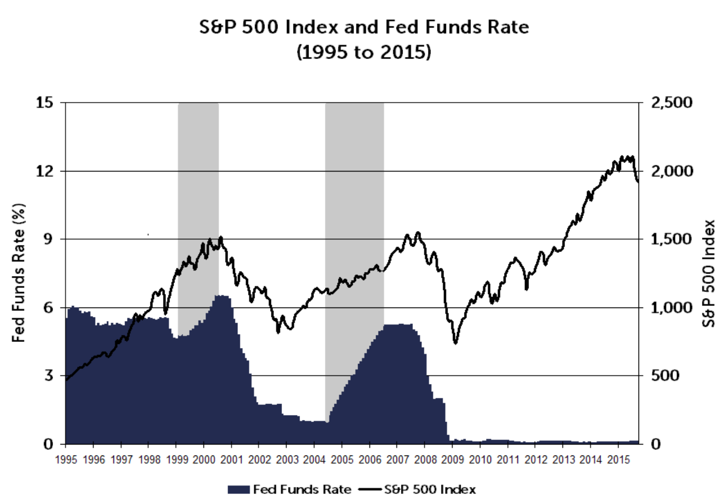
Rising Rates Won't End the Bull Market
Tony Demarin, MBA, CFA, CIM, FCSI

The last time that the United States Federal Reserve System ('the Fed') increased short-term interest rates was at its June 29th 2006 meeting. After almost ten years, investors are now expecting the Fed to raise short-term interest rates some time in late 2015 or early 2016.

The expectation of a rate increase has contributed to an increase in volatility in the capital markets over the last two months. Investors have become addicted to cheap money because the Fed has not increased rates in almost a decade and because short-term interest rates have been near zero since the end of 2008. Many investors believe that when interest rates begin to rise, the equity bull market will come to an end. Historically, this has not been the case. If the equity markets do decline after an interest rate increase, it will most likely represent a good buying opportunity.

Studies by BMO Capital Markets Research have suggested that corporate profits, economic growth and equity market performance (S&P 500 Index) have all performed better than normal in each of the last five interest rate increase cycles. (The previous two cycles have been highlighted in grey in the chart below.) This result makes intuitive sense as well because the interest rate increases occurred in periods of strengthening economic growth. Once the Fed begins to raise interest rates, market volatility could be lower than in past rate-hike cycles because the Fed has gone on record as saying that rates will be increased very slowly in an attempt to minimize capital markets disruption. It is also important to note that the starting short-term interest rate, the Fed Funds Rate, is currently at 0 to 0.25 percent, which is much lower than the starting point for the last five rate increase cycles. To put this into perspective, in the past six rate-hike cycles, the Fed Funds Rate was closer to five percent on average.



Source: Bloomberg LP

Interest rates should have a lot more room to increase before they present a headwind to economic growth and corporate profitability. This comfort comes from both the extremely low level of interest rates and the plan to increase those rates very slowly. Monetary policy generally works with long time lags, meaning that economic growth and corporate earnings should not decrease for some time yet. In practice, economic growth actually begins to accelerate in early in most interest rate-tightening cycles. Unless inflation starts to get too strong, which is clearly not the case today, and it causes the Fed to increase rates more aggressively, the economy and capital markets should perform fine even with the forthcoming interest rate hikes.

Equity markets typically decline only after repeated interest rate increases. As an example, the more aggressive interest rate cycles that began in 1998, 1999 and 2004 eventually led to recessions in the United States. The Fed can cause a recession and create a bear market for equities, if they are aggressively combatting inflation with interest rate increases. Inflation is not an immediate concern for the Fed, especially in light of their decision in September not to begin to raise interest rates. One key reason for this was that it felt that inflation still remained too low, particularly in the context of employment income and commodity prices.

Canadian Equity Market Update

Todd Johnson, B.Comm (Honours), CFA, CIM

Global equity markets have experienced considerable volatility over the last few months and the Canadian markets have not been spared. The last twelve months have been challenging for the Canadian equity market in general.

The financial and energy sectors are the two largest components of the S&P/TSX Composite Index, which encompasses the broad Canadian equity market. At the end of September 2015, the financial sector represented 37 percent of the index and the energy sector represented 19 percent. Over the past twelve months, the S&P/TSX Composite Index declined by 11.1 percent. In that same period, the S&P/TSX Equal Weight Diversified Bank Index declined by 10.1 percent and the S&P/TSX Equal Weight Diversified Energy Index declined by 39.8 percent.

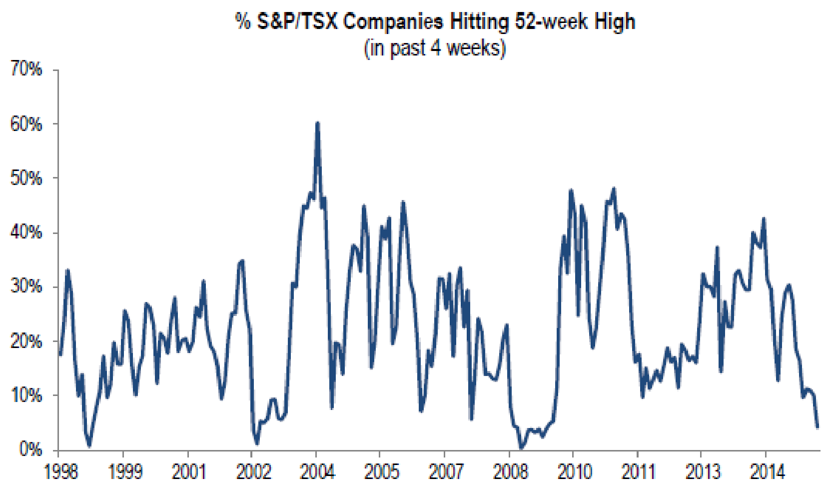
The falling price of crude oil has had a large impact on the Canadian stock market. The price of West Texas Intermediate crude oil ('WTI') peaked at around 107 dollars per barrel in June 2014. In September 2015, crude oil traded in a very narrow range around 45 dollars per barrel. The impact on oil-producing companies has been extreme, as 100 dollar per barrel oil was the new-normal price following the financial crisis. Few companies have balance sheets that are prepared for the new reality of prices that are half that standard.

The financial sector is one that has been pressured by the secondary effects of the fall in crude oil prices. While banks have generally reported strong earnings this year, concerns about energy exposure in their loan book and the secondary effects on consumer debt in light of weak economic growth in Canada have dominated investor perceptions on banking. There has been some short selling, mainly from United States-based investors on the expectation of worsening financial results, which has compounded the weak bank share price performance.

Those secondary effects have not been limited to the financial sector. The shipment of goods has been weaker resulting in falling share prices for Canadian National Railway and Canadian Pacific Railway Ltd. The real estate sector has been impacted by increasing investor risk aversion, resulting in many publicly-traded REITs trading below the value of their properties. Precious metal and base metal mining companies have also experienced a difficult year as they continue to deal with relatively low commodity prices and weaker Chinese economic growth.

Not all sectors of the market have been caught up in this downdraft. The healthcare and telecommunications sectors have increased year over year, but the positive impact is muted by the fact that they compromise only about 10 percent of the S&P/TSX Composite Index.

As it has been a difficult year for the Canadian equity market, with the six weeks between the middle of August and the end of September being particularly so. One measure of this pessimism is the percentage of companies in the S&P/TSX Composite Index that have reached a 52 Week High in the preceding four weeks. As the chart below shows, this broad-based weakness is near levels seen last in 1998, 2002 and 2008. We know that market weakness does not last forever and history has shown us that those three years turned out to be good buying opportunities. The future is unknown, but we believe that the valuations in many sectors of the Canadian market are attractive for long-term investors. For the companies that we are invested in, we are confident in their ability to generate earnings growth over the long term, along with increasing their dividends to shareholders. The macroeconomic environment is always difficult to predict, but patience is normally well-rewarded.



Source: BMO Capital Markets

Portfolio Commentary- UnitedHealth Group Inc.

Mark Lindal, B.Comm (Honours), CIM

During the previous quarter, we invested in UnitedHealth Group Inc. in investor portfolios. We wanted to use this edition of The Blue Chip Report to provide an overview of the company and to explain the rationale for making this investment.

UnitedHealth is the largest diversified managed healthcare provider in the United States. The company has experienced and will continue to experience significant growth because of the Patient Protection and Affordable Care Act of 2010. This Act, which is more informally known as ObamaCare, was passed to provide more Americans access to affordable, quality health insurance and to reduce the growth in health care spending by expanding the affordability, quality, and availability of private and public health insurance through consumer protections, regulations, subsidies, taxes, insurance exchanges, and other reforms. This represented the most significant regulatory overhaul to the healthcare system in the United States since the introduction of Medicare and Medicaid in 1965.

UnitedHealth operates two primary divisions, UnitedHealthcare and Optum. The UnitedHealthcare division provides healthcare benefits to subscribers through a network of 6,100 hospitals and 850,000 physicians and other healthcare professionals. This division includes four market segments- UnitedHealthcare Employer & Individual, UnitedHealthcare Medicare & Retirement, UnitedHealthcare Community & State, and UnitedHealthcare Military & Veterans- that are tailored to servicing three largest government health insurance plans (Medicare, Medicaid and Military) and to non-government plans. The Optum division provides support services for the delivery of healthcare benefits. This division includes OptumInsight (Health Data Analytics), OptumRx (Pharmacy Benefit Management), OptumHealth (Healthcare Delivery Services and Support) and Optum Technology (research, development and innovation). The UnitedHealthcare division generates approximately 65 percent of revenue and the Optum division generates the remaining 35 percent.

UnitedHealth has benefited from the introduction of ObamaCare, experiencing a cumulative 54 percent increase in revenues and a 57 percent increase in earnings since the legislation was passed. Since the financial crisis, the company has provided a 10 percent annual growth rate in revenue, a 12 percent annual growth rate in earnings and has increased annual operating cash flow from 5.6 billion dollars in 2009 to 8.1 billion dollars in 2014. The company also makes use of its dominant market position and strong cashflow for acquisitions, allowing it to continue on its strong growth trajectory. Analysts have projected that this will allow the company to increase revenue by approximately 100 billion dollars to 230 billion dollars in 2019. This revenue increase is projected to lead to a doubling of earnings per share and the dividend increasing by approximately 44 percent over that period. It is also expected that this will also allow the company to significantly pay down debt, reducing it from 19 billion dollars in 2015 to only 1.5 billion dollars in 2019.

We were recently able to meet with Dr. Richard Migliori, Chief Medical Officer for UnitedHealth Group, at the company's head office in Minnetonka, MN. This meeting provided a useful window into understanding the company's business today and its future direction. The company has been able to grow into a dominant position in the United States, but still has a very bright future.

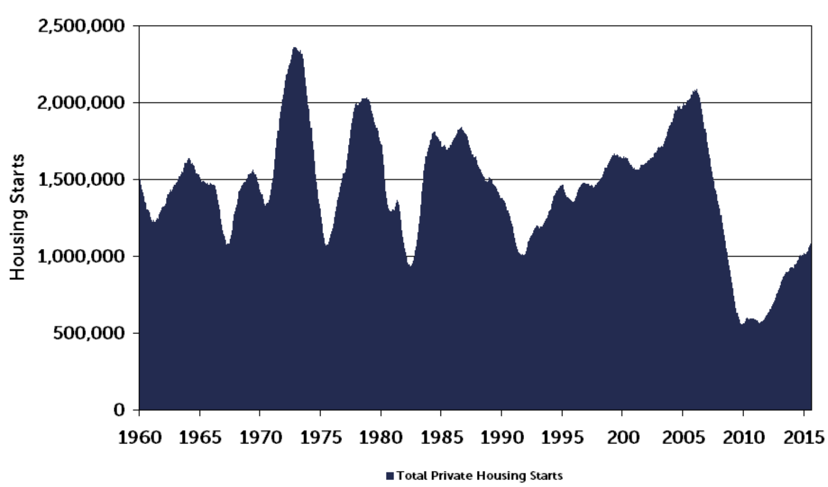
United States Home Improvement Sector

Chris Richard, BA, CFA

We would like to use this edition of The Blue Chip Report to overview the Home Improvement sector in the United States. This is a sector dominated by Home Depot Inc. and Lowe's Companies Inc., with other companies lacking one or both of the geographic footprint or product depth of the leading firms. We believe that this sector is well-positioned for long-term success.

The Home Improvement sector has seen its financial performance rebound in lockstep with the resurgence of the broader housing industry in the United States. We see a number of important indicators that suggest that this sector is well-positioned for continued growth. The first indicator is the level of private housing starts in the United States has only started to recover from the generational lows seen in 2008. While housing starts are starting to make impressive gains, we are still meaningfully away from the recent highs seen before the recession and the average over the preceding 20 years. The second indicator is the median age of a home in the United States has increased from 23 years old in 1985 to 35 years old in 2011. The home improvement industry is a logical beneficiary of the aging housing stock because owners have an increasing need to spend on maintenance and upkeep, as well as having an interest in spending on discretionary improvements.

United States- Total Private Housing Starts (Annual- Trailing 12 Months) (1960 to 2015)



We concur with analyst sentiment that home price appreciation has a strong correlation with how much people are willing to invest in their homes. When people feel that their homes are worth more, they are willing to invest more into their home. Not only are they willing to spend, they are willing to trade up into more expensive items, which often come with higher margins.

Finally, we also believe that demographic trends provide additional support to this sector. Currently, the baby boom generation provides the greatest proportion of spending on home renovations. While the early boomer should be slowing down on home renovation spending, we are finding that early boomers are working longer and postponing retirement, providing them with additional resources to invest in their homes. We are also seeing generation-Xers starting to increase their spending on home renovations as they enter their prime home renovation years. Finally, we also see the millennial generation starting to purchase real estate of their own. While affordability is a concern, we believe that long-term interest rates will not rise meaningfully in the near future, keeping mortgage rates at historically depressed levels and home affordability very accommodative.

We believe that there is potential opportunity in this sector, based on the growing strength of the economy in the United States and the financial strength and confidence of consumers. We also believe this sector will be supported by favourable interest rates, pent-up demand and favourable demographic trends, providing a framework for strong returns from the larger companies in this sector.

Recent Dividend Increases

Canada

Third Quarter 2015:
Bank of Montreal: 82 cents (80 cents)
Canadian Imperial Bank of Commerce: 109 cents (106 cents)
Cenovus Energy Inc.: 16 cents (26.2 cents)
National Bank of Canada: 52 cents (50 cents)
Saputo Inc.: 13.5 cents (13 cents)
Suncor Energy Inc.: 29 cents (28 cents)
TELUS Corporation: 42 cents (40 cents)

Fourth Quarter 2015 (Pending Increases):
Bank of Nova Scotia: 70 cents (68 cents)
Callidus Capital Corporation: 17.5 cents (Initial Dividend)
Canadian Imperial Bank of Commerce: 112 cents (109 cents)
Royal Bank of Canada: 79 cents (77 cents)

United States

Third Quarter 2015:
JPMorgan Chase & Company: 44 cents (40 cents)
Medtronic Inc.: 38 cents (30.5 cents)
U.S. Bancorp: 25.5 cents (24.5 cents)

Fourth Quarter 2015 (Pending Increases):
Microsoft Corporation: 36 cents (31 cents)
Verizon Communications Inc.: 56.5 cents (55 cents)

Dividend Increases reported in domestic currency of common shares, except where noted.
* Dividend paid in USD.
Source: Bloomberg LP