



JUNE 2019 QUARTERLY OUTLOOK

TRADING WELL OUT OF THE BLOCKS

Main Themes

Sectors and Stocks to Consider



FAIRMONT EQUITIES



MAIN THEMES

- **2019 Progress Report – Recapping our Earlier Expectations**
Late last year we outlined our expectations for a more positive 2019 than the consensus held at the time. Broadly speaking, central bank policy is moving towards our view and equity markets have indeed recovered their losses from 4Q/2018. Sectoral performances generally reflect improved expectations.
- **Central Banks, Yield Curves and George Costanza**
While central bank's QE programs have driven the significant flows into bond markets, a more gradual unwinding of QE was our expectation given the need to be deliberate. However, in the process, central bank policy has largely rendered yield curves models of the business cycle less effective at forecasting growth than they were prior to the QE distortions. As such, we believe any risk to equities is investor sentiment, not economic fundamentals.
- **Valuation**
Equity valuations compare favourably with trend valuations suggesting solid support for multiple expansion to help drive equities further. Valuations of equities versus bonds are also attractive given the expensive bond market. Sectoral valuations remain broadly supportive of our cyclical portfolio stance.
- **Volatility – George Costanza is Lurking**
We do need to be aware of the risk of market participants rushing for the exit on what seems to be sometimes whimsical sentiment shifts. However, equity market volatility has reached elevated levels when compared to bond market volatility and should compress. We believe this will be accompanied by a flow of capital away from bond markets into equity markets.
- **Risk Management is Key**
Being aware of potential sentiment driven shifts in global equity risk is important. The largest declines in equity markets are usually by the most volatile stocks. Protecting portfolios by reducing unnecessarily volatile stocks, and maintaining a high-quality core portfolio is recommended.
- **Sectors and stocks**
We remain focused on a combined portfolio strategy of higher quality core portfolio holdings and opportunistic thematic trades. We like BHP, RMD, MQG, GMG, ALX, APX, and select energy names.

Heading into year-end in 2018 we outlined our expectations for an improvement in the outlook for equity market returns as 2019 progressed. At the time, global equity markets were gripped with fear, focus was relatively short-term, and political and economic uncertainty was driving capital flows on a serpentine trajectory that fed fear further. We were of the view that the global growth outlook remained supportive for equities and that overly pessimistic expectations would shift to a more positive view, providing the fuel for a supportive tide of capital flowing back into equity markets. While nothing much has fundamentally changed since then, in that risk to equity markets is centred on the US Federal Reserve and trade developments surrounding China, the market is very clearly more aligned with our view of 2019. Equity markets have rallied into 2019 and started the year very solidly out of the blocks. Other risk assets such as the commodity markets are also showing signs that a more supportive consensus is building.

Despite the strong start to 2019 though, equities are not without risk given the speed of the rally and the proximity to prior highs. The very clear separate reactions of the equity market to the shift in the US Federal Reserve's interest rate demeanor and then the yield curve inversion suggest that equity market participants are squarely placed near the exit door in case the outlook deteriorates suddenly. Here lies the main risk of correction in our minds. We remain confident the growth outlook is supportive of equities and that trade negotiations will end positively. The big risk is that sentiment in the global equity markets appears fragile enough to shift rapidly and thus possesses self-reinforcing potential for a correction based purely on the so-called "greater fool theory" – selling before others can sell.

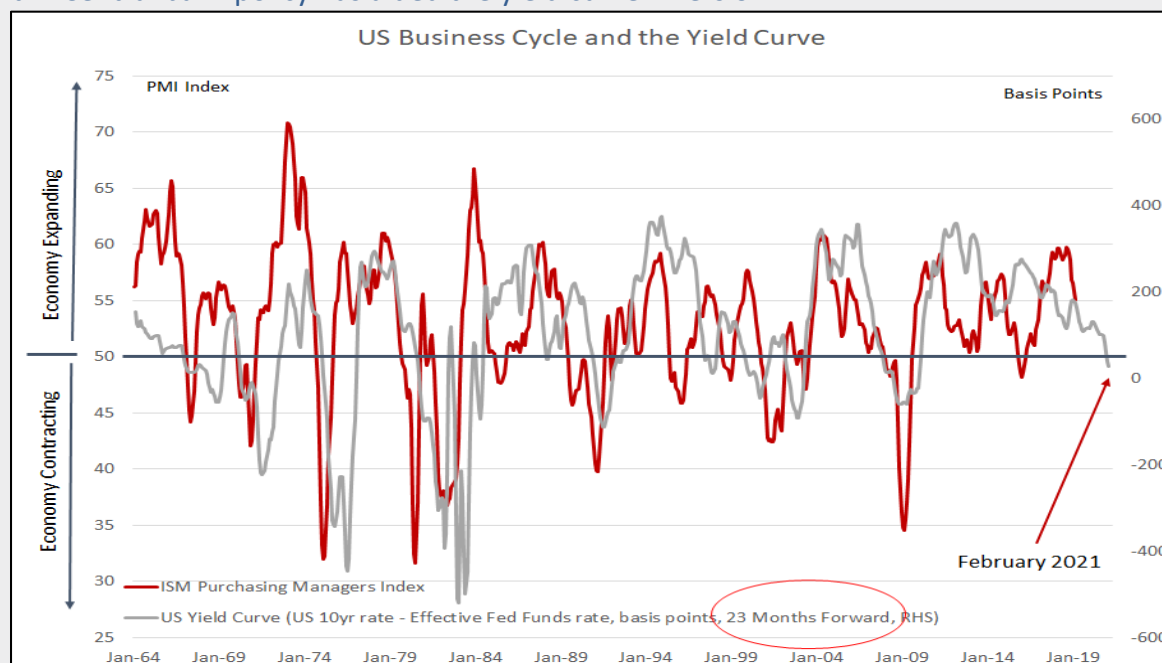
CENTRAL BANKS, YIELD CURVES, AND GEORGE COSTANZA

Last year we took the view that the US central bank would spend most of 2019, if not all of 2019 on-hold. Indeed, only three months after publishing this view, rates markets are now pricing the potential for LOWER rates in the latter part of 2019. This is a very distinct shift in outlook for markets, but it's because the Fed signaled a very clear shift in official policy stance in March. We were of the view that the Fed needed to be data driven, and indeed, in keeping with their experience in steering the US economy through past growth and contraction cycles, policy has typically been conducted in a counter-cyclical fashion. It now seems the Fed has taken the data very seriously into consideration in that lower commodity prices have been suggesting slowing economic growth and moderating input pricing at some point over the next year or so. The Fed aims to support an extension to the current growth cycle. As we suspected in December 2018 and wrote in our previous market outlook, the Fed has moved from market headwind to market tailwind.

Or has it?

Equity markets have a long and distinguished history of making even the most astute investors look deficient at times. Sentiment often shifts from reading economic and political developments as supportive to reading the same events as destructive. One could argue that the Fed holding rates lower for longer is supportive of equities. Excellent, it's time to break out the punch and party hard. One could just as easily take the view that the Fed is holding back because it has assessed the US and global economy as not being strong enough to take policy tightening at this stage (or whenever). Quick, look for the nearest exit and hope George Costanza isn't behind you trying to get out at the same time (the greater fool, more on this shortly).

Chart 1: Central bank policy has aided the yield curve inversion



Source: Federal Reserve of St. Louis, Fairmont Equities

While we hope for the former, the risk of the latter remains. Hence our need to remain vigilant (more on this later). As such, thinking about the market's reaction to the yield curve inversion warrants a cautionary note that central banks have essentially



placed the bond markets forecasting ability into question. The massive security purchases that have resulted from central bank QE programs has created an artificial interest rate across the entire yield curve maturity spectrum.

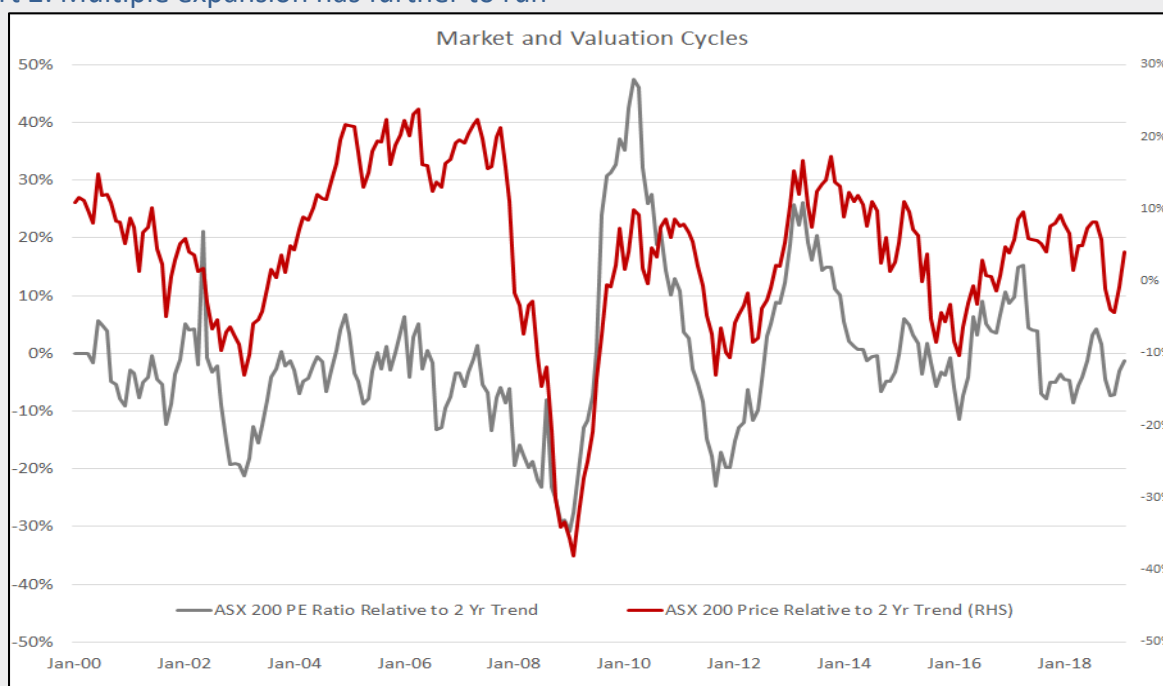
The mathematics of the time value of money are being tested sorely. As such, while the yield curve has always been part of the macro analyst's most preferred models in the toolkit, we'd caution its religious use as may have been the case in the past. As such, while the average lead time is around 19-24 months, we need to take any February 2021 recession predictions with a grain of salt.

The upshot is that while we remain of the view that growth rates will remain elevated for a time, but then compress, outright economic contraction is still a late 2020 phenomenon, and there remains significant upside potential for global equities during 2019.

VALUATION

Any potential for equities to continue to perform well would rely in part on multiple expansion. When we compare the current growth backdrop to the 2004-07 period when central banks had already been tightening monetary policy, equity markets provided excellent returns and reached peak valuation levels but then remained at elevated levels relative to trend valuations. In Chart 2 below, the grey series shows the ASX 200 PE ratio relative to the two-year trend. Valuations are cyclical and appear to be at a relatively low level when compared to past cycles, suggesting room for multiple expansion.

Chart 2: Multiple expansion has further to run



Source: IRESS, Fairmont Equities

When we compare equity valuations to bond valuations, the argument becomes even more compelling. Chart 3 over the page shows the earnings yield-bond yield ratio at elevated levels commensurate with cheap valuations after the GFC and following the 2012 and 2016 bouts of market weakness. In each of these instances, equity markets rallied significantly. The central

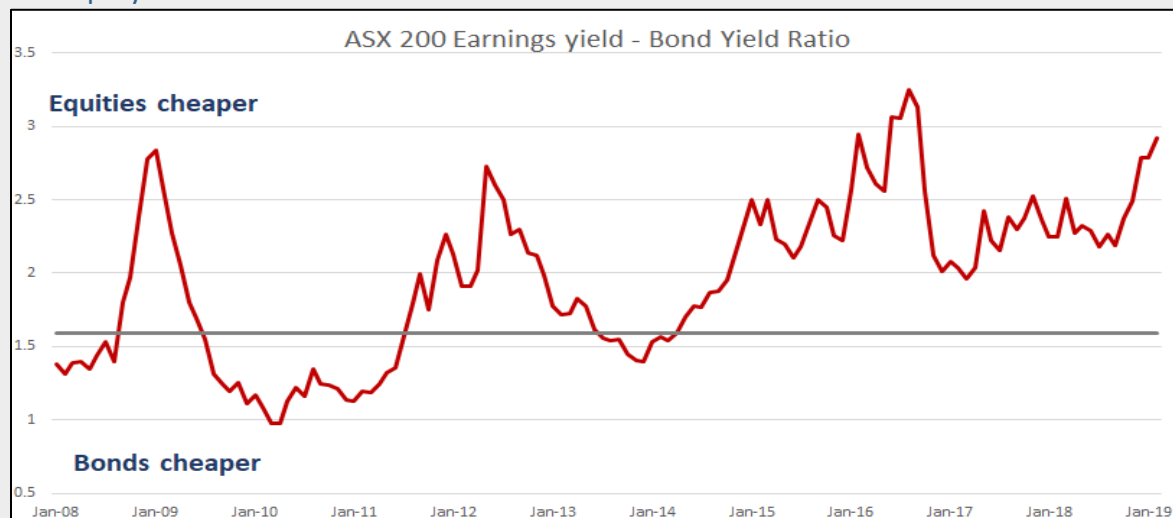


bank QE programs have driven the huge flood of capital into bond markets and contributed significantly to the compression of bond rates. Even adjusting for volatility, bond returns have little room for error. At such extremes, capital flows in search of higher returns can be a significant force for equities given the asset allocation shifts between equities and bonds.

Breaking valuations down to sectors and styles in Chart 4 over the page is also instructive in isolating the potential for multiple expansion over the remainder of 2019. Despite the significant performance of the sector, high quality property names remain attractive, and where exposure is more warehouse relative to office or residential, we think the sector still makes solid sense. Companies like Goodman Group remain favourites of ours given the very low level of volatility the stock typically trades with. Other sectors that seem attractive because of favourable valuations include consumer discretionary. However, the sector is cheap due to fundamental reasons and we'd generally avoid these stocks (except for a very select few) in favour of better opportunities elsewhere. Select financials are attractive on valuation grounds and we favour insurers given the murky outlook for banks. In terms of style, large caps have outperformed small caps in line with our expectations late last year but are now only marginally cheap. Small caps are marginally expensive, and we'd be selective given potential for illiquidity risk.

The most expensive sectors are healthcare, tech, industrials, and staples, suggesting caution when investing given the risk of valuation-driven weakness.

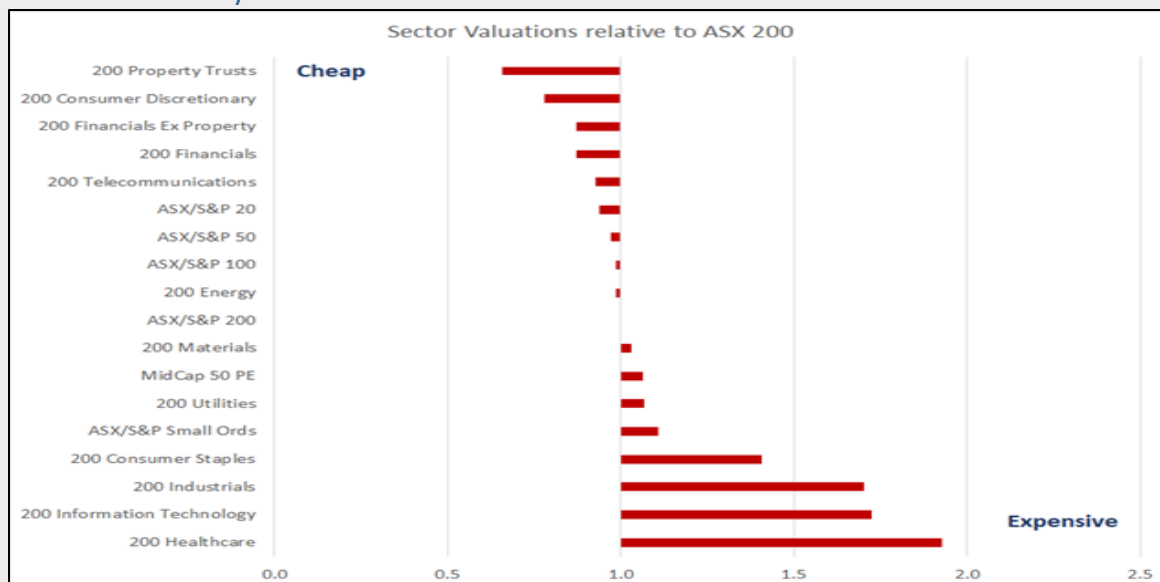
Chart 3: Equity Valuations are attractive relative to bonds



Source: IRESS, ASX, Fairmont Equities



Chart 4: Sector and Style Valuations



Source: IRESS, ASX, Fairmont Equities

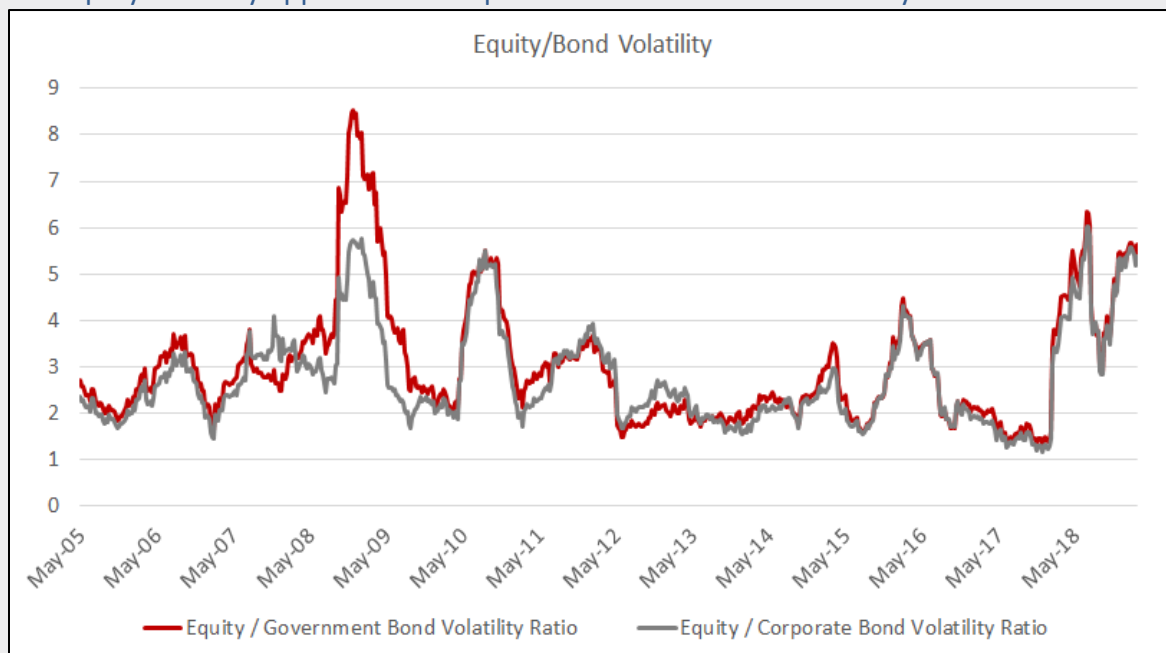
VOLATILITY - GEORGE COSTANZA IS LURKING

For anyone not acquainted with the hapless character of George Costanza from the US hit TV show Seinfeld, George once rushed so aggressively for the exit door amid the threat of fire in an apartment building that he shamelessly and indiscriminately trampled over or pushed past children and elderly ladies to save his own skin. As funny as this scene was, it highlights behavior that equity investors need to be wary of following the market reactions to 1) the Fed stepping back; 2) the yield curve inversion; and 3) building consensus that the rally has been overly aggressive and unwarranted. Investing can sometimes be as much about assessing another investors' sentiment as much as our own. The stock market is an emotional beast and understanding what the broader stock market might be fearful of is vital prior to participating.

Broadly speaking, equity markets are more volatile than bond markets. This has been a consistent capital markets theme since the dawn of the markets. Yet, equity volatility is mean-reverting by nature and 4Q/2018 saw equity volatility rise, particularly when compare with bond and corporate credit markets (Chart 5 below). This is typical during equity market weakness and credit dislocations such as the GFC. What is interesting during the most weakness period of market weakness during 4Q/2018 was that volatility appears to have peaked when compared to the bond market and should compress. Any absence of bad news will drive equity volatility lower relative to bond volatility.



Chart 5: Equity volatility appears to have peaked relative to bond volatility

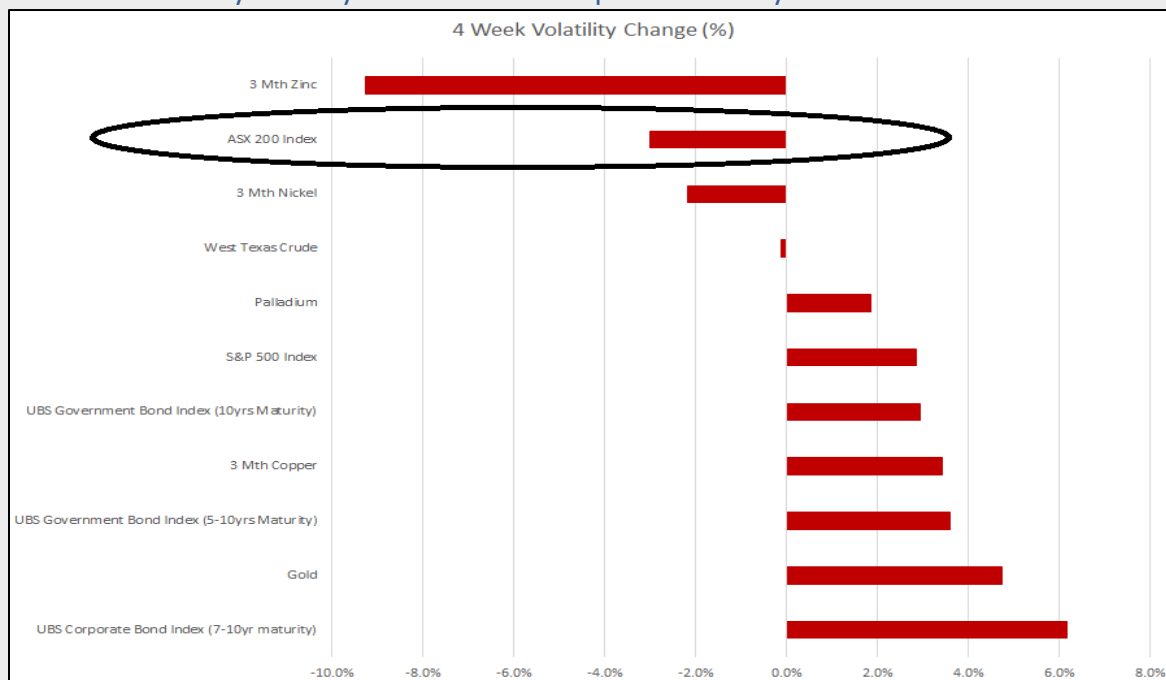


Source: Commodity Futures Trading Corporation (CFTC), Federal Reserve of St. Louis, Fairmont Equities

This is reinforced by the fact that the recent yield curve scare in the US has seen bond volatility rise at a fast rate for a short period than equity volatility (Chart 6). Indeed, over a broad range of asset classes, volatility trends were not typical over a recent four-week period surrounding the recent yield curve scare. The bond market has been hypersensitive to the global growth outlook. While equity markets are more volatile than bonds markets generally, the ASX 200 volatility actually fell during this period, and bond volatility actually rose and posed a very clear risk to equity stability. While the yield curve inversion scare appears to have subsided, equity markets will remain focused on the volatility of bond yields as a measure of where the smart money is looking, and positive news from China trade negotiations with the US will be welcomed.



Chart 6: Bond volatility actually rose more than equities recently



Source: IRESS, Fairmont Equities

RISK MANAGEMENT IS KEY

Ultimately our central thesis for 2019 remains intact with a broadly supportive economic backdrop globally. From a macro perspective, trends take time to develop, yet we are always conscious that capital prudence is key to success.

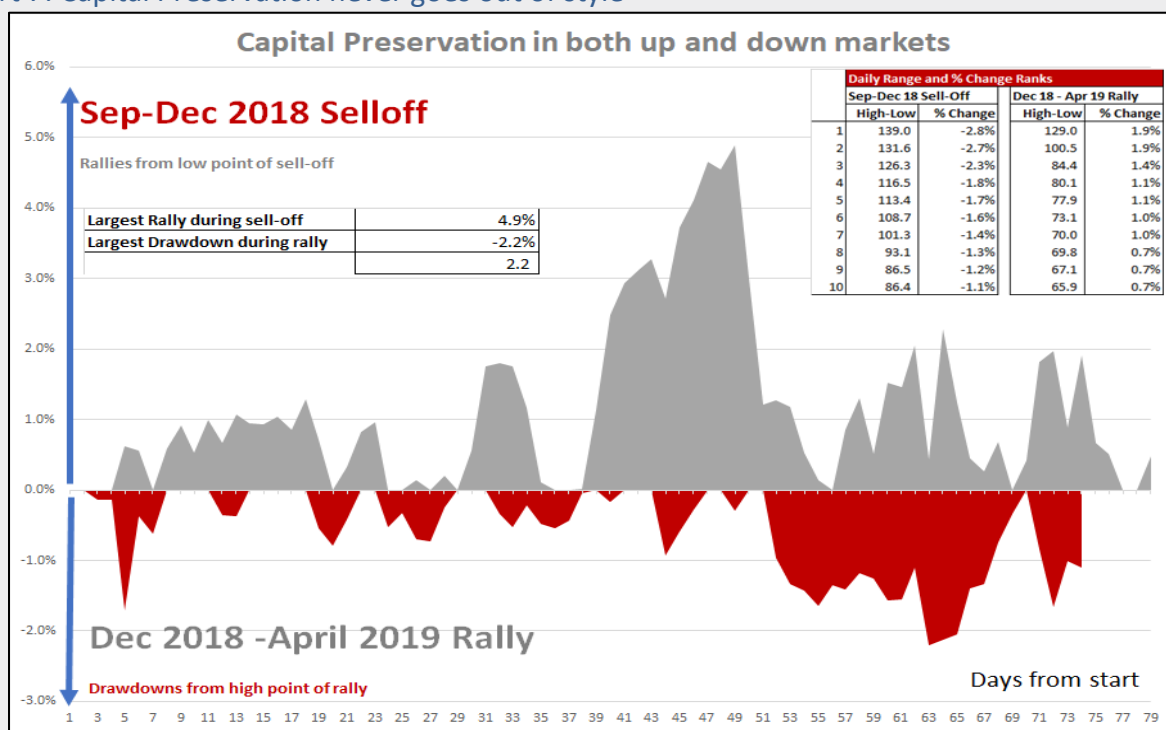
Chart 7 over the page shows a comparison of the sell-off from late 2018 with the rally since late December 2018. This chart is an important illustration of the factors of risk that every investor should understand. Two elements of this chart are worth noting:

- 1) For both the late 2018 selloff, and the current rally, the table in the upper right corner of the chart shows a comparison between the largest ten daily ranges between the high and the low of the day, as well as the largest ten percentage moves over a single day. In terms of daily ranges between the high and the low, it is very clear that there are many more ranges of 100 points or more during the sell-off than there have been during the rally. The same applies for the largest daily percent moves. They tend to be larger during a sell-off than during a rally.
- 2) The grey section above the line shows the rallies from subsequent low points during the decline at any point in time. The red section under the horizontal axis is the drawdown from the highest point reached during the rally up to any point in time. The horizontal axis shows the number of days since the move began. What these two sections show is that short and sharp rallies during the market selloff are larger than the declines from peaks during the rally. The largest rally during the Sep-Dec 2018 market decline was +4.9%, more than twice as large as the largest drawdown during the rally since. This is an important element to understand as the takeaway is not that declining markets offer good rallies to trade, but that declining markets typically contain short and sharp moves upwards that can 1) shake out investors wanting to stop



their pain; and 2) ,shake out short positions that need to quickly buy to cover their unlimited downside risk should markets continue to move higher again. Both these types of fear reaction result in only one outcome – higher volatility during declines. Higher volatility equals higher risk.

Chart 7: Capital Preservation never goes out of style



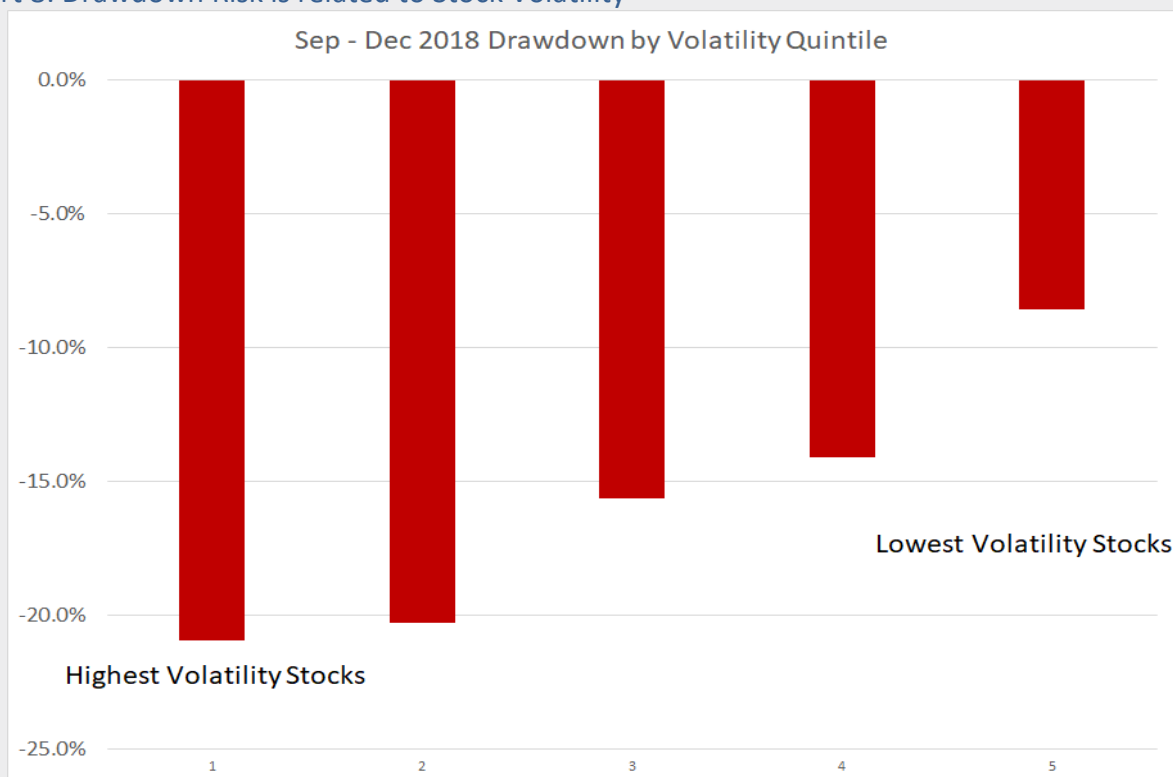
Source: IRESS, Fairmont Equities

Points 1 and 2 above are precisely why solid portfolio management is highly dependent upon maintaining disciplined risk management as the core concept. By using an approach that utilises protective trailing stops we aim to achieve the twin benefits of 1) locking in profits as trades develop favourably; and 2) manage risk by removing potentially negative portfolio contributions from stocks that pose a risk of declining.

To reinforce this, Chart 8 over the page highlights the ASX 200 stocks broken down into quintiles, ranked on stock 30-day historical volatility at end-August 2018. The very clear message from the chart is that the most volatile of stocks lost the most value during the decline. As much as we want to trade strong stocks during a rally, we also want to remove the largest sources of potential risk when markets look on shaky ground. We don't believe the market is necessarily on shaky ground right now, but we need to remain cognisant of broader sentiment shifts that might signal the need to reduce risk, and be more focused on quality exposures.



Chart 8: Drawdown Risk is related to Stock Volatility



Source: IRESS, Fairmont Equities

SECTORS AND STOCKS TO CONSIDER

This is the main reason we continue to follow our two-pronged framework that reflects 1) potential for an extended global business cycle; and 2) investing in companies that regardless of the cyclical outlook, are best in industry, high quality companies. We have been active over the past quarter building client exposures in stocks such as Goodman Group (GMG) and others that can assist in maintaining a very strong core equity portfolio exposure and adding other, more aggressive trades when opportunities arise.

The main sector preferences remain as follows:

- High quality cyclicals over defensives
- Select Resources and Energy
- Interest rate sensitive stocks
- Select Gold
- High Quality Growth



FOCUS STOCKS

The following are stocks on our watchlist for the time being, but this list will change over time. There are also plenty of other stocks that we are “trading” alongside these major names, so make sure you are receiving [The Dynamic Investor](#) to be kept up to date with our favourite ideas.

BHP (BHP, large cap cyclical, POSITIVE):

Fundamental: The central thesis of an extended cycle remains intact and should be supportive of BHP through 2019. However, the speed of the recent advance, driven by the Vale supply restriction, places this stock in tight focus.

Technical: The test for BHP will be how well it can hold \$40 and then move progressively higher. We remain invested but are managing trailing stops to ensure solid returns from the rally are locked in.

CSL (CSL, Premium Stock, POSITIVE):

Technical: CSL looks to be comfortably settling back above \$200 which should provide a solid foundation from which to move higher again should the broader market be supportive.

Macquarie Group (MQG, Premium Stock, POSITIVE):

Fundamental: MQG is to the Australian stock market what Nomura and Daiwa are to the Japanese stock market. When the market recovers, as a leveraged play on markets, you want to own some. MQG remains attractive stock with solid potential for future upgrades to guidance should be a major catalyst for the share price in 2019.

Technical: MQG is establishing good support near the \$130 area and has shown some great strength on positive days. Any dip is a buying opportunity.

Santos (STO, Oil & Gas, POSITIVE):

Technical: While we remain positive on energy prices in 2019, news that the Norwegian pension fund is reducing Australian energy stock holdings, together with suggestions the Russian authorities are not supportive of ongoing crude production cuts past June 2019 suggest that caution is warranted. Indeed, volatility has picked up among the energy sector stocks and trailing stops to protect positions is recommended.

ResMed (RMD, Premium Stock, POSITIVE):

Fundamental: RMD is a global leader in treating sleep apnoea, a potentially huge market opportunity. The company remains a highly valued growth stock with dominant market share, stable gross margins, consistently positive sales growth, and an expanding product suite. Its recently announced acquisition of Propeller Health should further assist that.

Technical: RMD was sold off aggressively in January amid results season and lofty expectations yet remains attractive. We took this opportunity to add to existing positions where portfolio weights allowed, and remain confident the share price will once again reflect its outstanding credentials.

Goodman Group (GMG, Premium Stock, POSITIVE):

Fundamental: GMG is a high-quality defensive growth stock that we like very much. Its strong earnings growth profile remains very low risk, driven by improving rental growth, strong growth in assets under management and improved profitability of its Funds Management division. 2019 should be a good year for GMG as we expect it to beat its own profitability guidance when annual results are delivered.

Technical: GMG continues to move gradually higher and outperform the broader markets in a very orderly manner. We continue to invest in this name for clients.



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ABOUT US

FAIRMONT EQUITIES

Fairmont Equities is a boutique share advisory firm assisting Private Clients with the professional management of their share portfolio. We uniquely combine both technical and fundamental analysis. We are based in the Sydney CBD but provide services to private clients across Australia.

MICHAEL GABLE

Michael is the Managing Director and founder of Fairmont Equities. He has over 15 years' experience in Financial Services. Michael believes that investors can do better by combining both technical and fundamental analysis. After realising that there was a gap in the industry for this type of advice, Michael founded Fairmont Equities in 2013. His specialty is in technical analysis. He uses these skills to help clients pick the right entry and exit points.

Michael is RG146 Accredited and holds the following formal qualifications:

- Bachelor of Engineering, Hons. (University of Sydney)
- Bachelor of Commerce (University of Sydney)
- Diploma of Mortgage Lending (Finsia)
- Diploma of Financial Services [Financial Planning] (Finsia)
- Completion of ASX Accredited Derivatives Adviser Levels 1 & 2

GORDON ANDERSON

Gordon's career began trading futures and options at the Commonwealth Bank in Sydney before moving to Asia where he was an institutional equity portfolio strategist with Morgan Stanley. He returned to Australia to manage the equity long/short investment strategy at hedge fund Basis Capital across all Asian markets including Japan, before leading global macro trading teams at one of South Africa's largest banks, Rand Merchant Bank and Visor Capital in Kazakhstan, responsible for discretionary macro investments across global equity, bond, commodity and currency markets. More recently, Gordon returned to Morgan Stanley, where he was responsible for portfolio strategy in equity and fixed income markets, asset allocation, and advised high net worth clients and family offices on international and derivative investments.

Gordon holds the following qualifications:

- Bachelor of Economics [Distinction] – (Western Sydney University)
- Bachelor of Applied Science [Physics] – (Western Sydney University)



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