



FAIRMONT EQUITIES

Equities Roadmap for 2019

DECEMBER 2018

P.1

EQUITIES ROADMAP FOR 2019

WHY 2019 COULD SURPRISE INVESTORS

Main Themes

Sectors and Stocks to Consider



FAIRMONT EQUITIES



MAIN THEMES

➤ **US Federal Reserve Policy a 2019 Tailwind**

Unlike past Fed tightening cycles that have been accompanied commodity price strength, this cycle has seen commodity prices decline. We're 37 months into the current tightening cycle and we believe the Fed may hold in 2019. The Fed thus transitions from a market headwind to a market tailwind in 2019.

➤ **Growth and Inflation Outlook**

We believe the global growth remains on a healthier footing than some folks believe and we are of the increasing view that the consensus has become overly pessimistic. While US economic growth is moderating, it does not appear that the US is heading for recession by any means. Even excluding the potential for this economic cycle to be extended, the US economy is unlikely to slow to the point of contracting until late 2019, providing ample support for further solid gains by the stock market.

➤ **US dollar Outlook**

As the Fed's tightening cycle winds down, the gap between US rates and non-US rates should narrow, as differences in central bank actions narrow. During this cycle, the interest rate differential has supported a strong US dollar, but we'll likely see this differential compress as non-US yields catch up and be less supportive of the US dollar during 2019. More stability, or a lower US dollar will support risk assets, and an equity recovery.

➤ **Global Capital Flows**

Should the economic cycle be extended and a more stable US dollar ensue, major trends we are likely to see include equities outperforming other asset classes, cyclical outperforming defensives, and large caps dominating small caps.

➤ **Gold Outlook**

With a more stable US Dollar outlook gold prices look set to perform solidly during 2019. Net positions in gold are currently significantly net short when compared to history, suggesting a very powerful potential source of buying power. Select gold stocks should be well supported.

➤ **Sectors and stocks**

An extended economic cycle where Fed tightening winds down would favour cyclical, large caps, select resources and energy, and interest rate sensitives. The potential for a more stable US dollar favours gold stocks, and we remain focused on adding select high quality growth stocks with dominating market share. We like **BHP, ALL, RMD, MQG, GMG, STO, and NST**.

As Christmas approaches the outlook has shifted forward to the coming year and the outlook for equity markets. Globally, economic and political uncertainty during 2018 have contributed to a very short-term focus among global investors and a habit of reacting to intermediate data points that may well ultimately prove more benign for equities than currently expected. We believe that global growth remains on a healthier footing than some folks and we are of the increasing view that the consensus has become overly pessimistic. This has fueled volatility and driven an environment whereby fear has tended to overwhelm economic data and news that actually stands fairly solidly, in our view. Indeed, while the outlook for Australian equities within a global context will ultimately prove equally determined by actions of the US Federal Reserve and trade developments surrounding China, several important factors worth considering may well support a more positive 2019 outlook for global equities, and by extension, the Australian stock market.

US FEDERAL RESERVE POLICY – 2019 TAILWIND

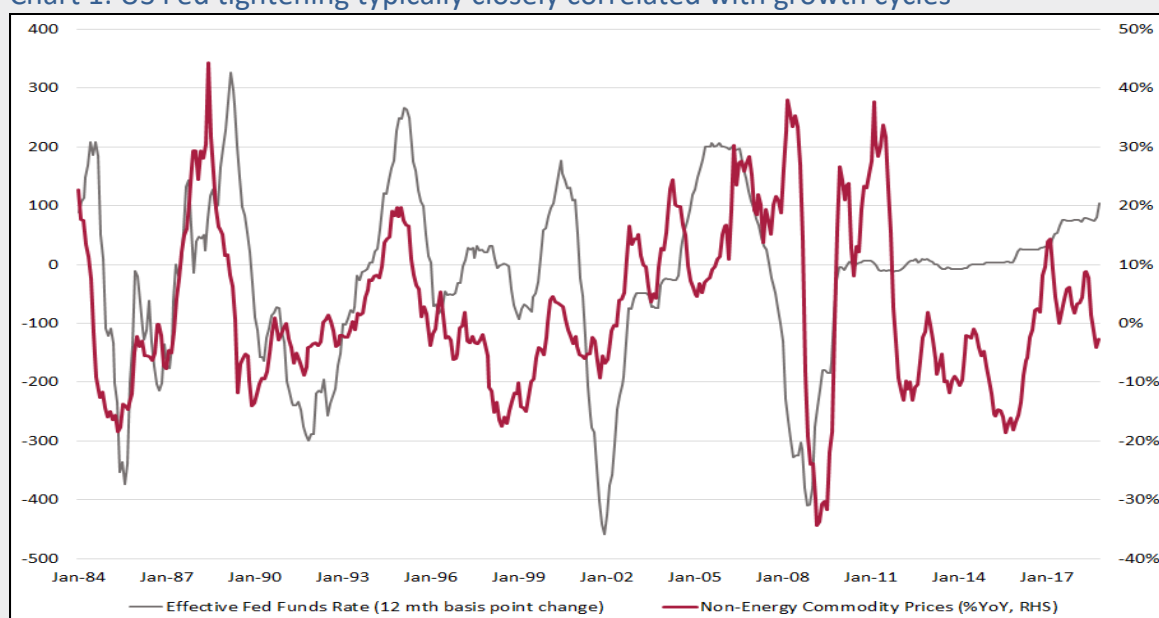
The US Federal Reserve's tightening phase during this cycle is coming up on just over 37 months now with this week's 25bps increase. This of course follows the longest period in history where rates have been on-hold following a cutting cycle. While the prospect of higher rates has certainly been one of the main themes to have spooked the equity markets, we think a scenario where the Fed possibly pauses following a period of extended monetary tightening could well be very supportive of the equity market.

This was certainly the case in 1995 when the US tightening cycle concluded after about 16 months, and the US stock market went on to explode and rally through to July 1998 when the Asian crisis escalated. It was also the case in 2006 when the US Federal Reserve held rates from July after 25 months of tightening. Equity markets continued to rally a further 21% until peaking in October 2007.



The Fed needs to remain data driven with regard to their mandate of maintaining maximum employment while keeping inflation centred on its 2% objective. However, it could be argued that even this month's 25bp increase in official rates was heavy-handed amid equity market weakness. Nevertheless, we still think there is a significant possibility that the Fed then spends most of 2019, if not all of 2019 on-hold for a very important reason. Past Fed tightening cycles were typically carried out in a counter-cyclical fashion, corresponding to an expansion in business cycle indicators in order to prevent overheating. Situation normal. This cycle sees a new dynamic where commodity prices have been weakening, suggesting slowing economic growth and moderating input pricing at some point over the next year or so. The Fed will need to be very cautious of further tightening monetary policy looking into 2019 as it could well pose a threat to any extension to the current growth cycle the Fed is hoping to engineer. In that sense, the Fed potentially moves from being a market headwind to a tailwind.

Chart 1: US Fed tightening typically closely correlated with growth cycles



Source: Federal Reserve of St. Louis, World Bank, Fairmont Equities

GROWTH & INFLATION

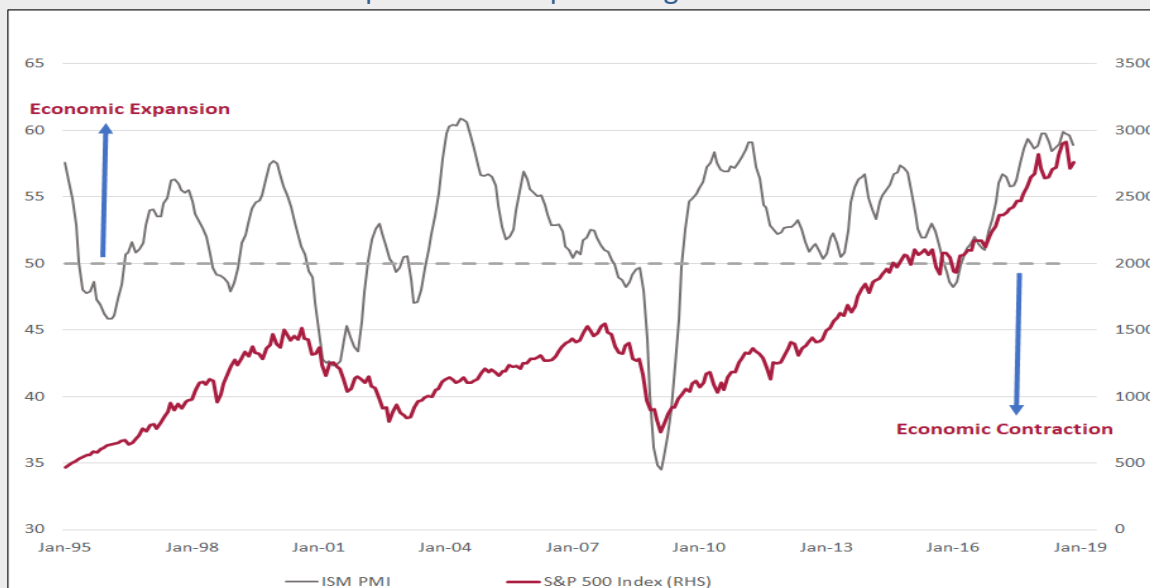
We believe that global growth remains on a healthier footing than some folks believe and we of the increasing view that the consensus has become overly pessimistic. This has fueled volatility and driven an environment whereby fear has tended to overwhelm economic data and news that actually stands fairly solidly, in our view. While global growth will likely moderate in 2019 from just under 4% to around 3.5% according to most forecasts, these remain reasonable levels of growth and are supportive of equities. While the US economic growth is moderating, it does not appear that the US is heading for recession by any means.

Indeed, we'd be much more concerned about very high rates of economic growth as they tend to be associated with risk of overheating, followed by policy overreaction. On the other end of the scale, an outright deflationary economic backdrop is particularly dangerous environment for equities. Clearly, we are nowhere near this scenario.



Considering the US stock market still accounts for just over half of the total market capitalization of the global stock market, it will remain the dominant driver of the Australian stock market. Measured economic growth, along with relatively low unemployment numbers in the US suggest that there is little scope for inflationary pressures, particularly given the wages growth registered already during 2018. Taken together, we think there's a real possibility the US economic cycle could be extended. Broad indicators such as corporate capex remain sound and looking ahead, US corporations aiming to deploy capital expenditures won't be able to do so over short periods of time. Implementing capex programs are likely to provide additional growth support for a longer period as these capital expenditures wash through the US economy. The stable outlook for the USD (see below) also suggests less inflation risk. Taken together, these developments again suggest a supportive environment for the cycle to be extended and equities to outperform other asset classes.

Chart 2: Stock markets still perform from peaks in growth



Source: Federal Reserve of St. Louis, World Bank, Fairmont Equities

Even without this potential support for an extended cycle, we'd highlight that reasonably orderly retreats from peak rates of growth are typical rather than sharp declines into recession. Earlier this month, the release of the latest Institute of Supply Management (ISM) Purchasing Managers Index suggested that activity across the US manufacturing sector remains robust at high levels, and therefore expansionary (Chart 2). The all-important reading of 50 on the ISM PMI delineates expansion from contractionary rates of US economic growth. At PMI readings above the critical 50 reading, the US economy is expanding.

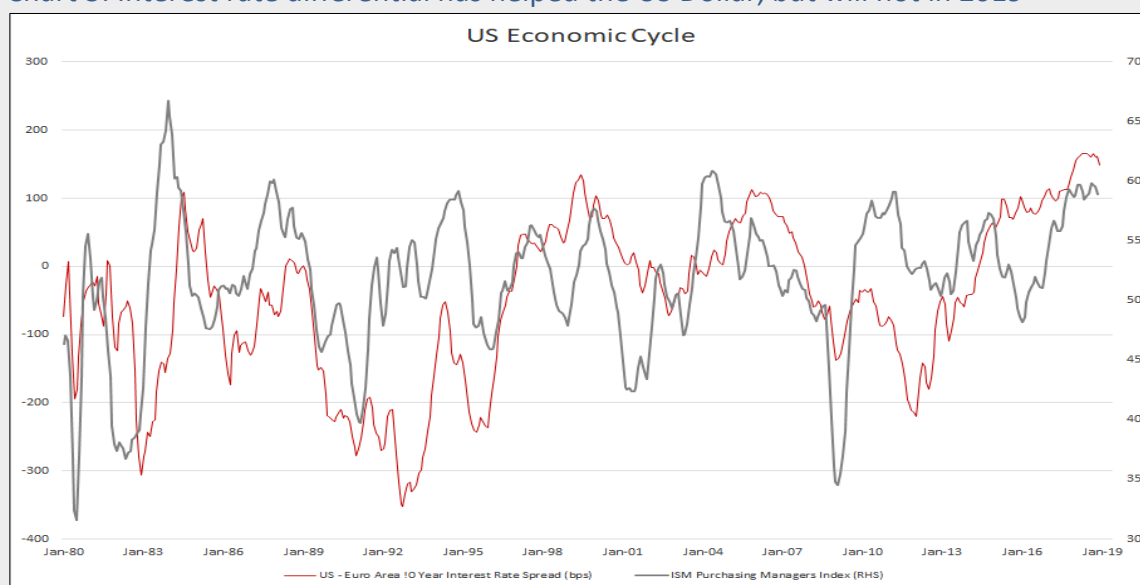
Over time, there is a very clear trend for the US stock market to rally during expansionary phases of the cycle. The 2004-2007 period is a case, but more so the 2009-2016 period where the US stock market rallied for an extended period throughout two moderating activity cycles that remained expansionary. In the last five moderating cycles of the ISM indicator since 1995 that resulted in eventual contraction, the US stock market declined four times, but **only after** economic growth rates moved from an expansionary phase to a contractionary phase. The time taken to make this move has averaged about eleven months from peak growth. Even excluding the potential for this economic cycle to be extended as we postulated above, this suggests that the US economy is unlikely to slow to the point of contracting until late 2019, providing ample support for further solid gains by the stock market.



US DOLLAR OUTLOOK: CENTRAL BANK CONVERGENCE & CALMER GEOPOLITICS

The outlook for the US dollar will be a critical factor in the equity market being supported. Further surges in the USD would seem unlikely given the growth outlook above. As the Fed's tightening cycle winds down, the gap between US rates and non-US rates should narrow, as differences in central bank actions narrow. The policy tightening path for both the European Central Bank (ECB) and the Bank of Japan (BoJ) are likely to become more closely aligned with the US as they too manage their respective monetary policy settings to guide their economies smooth progression forward. Chart 3 below shows the interest rate differential between the US and European 10-year government bond rates. What is very clear in the chart is the cyclical nature of this interest rate spread as interest rates reflect the US growth cycle. During this cycle, the interest rate differential has supported a strong US dollar, but we'll likely see this differential compress as non-US yields catch up and be less supportive of the US dollar during 2019.

Chart 3: Interest rate differential has helped the US Dollar, but will not in 2019



Source: St. Louis Federal Reserve, Fairmont Equities

While interest rate spreads are an important element of the outlook for the US dollar, other factors that played a strong part in US dollar strength during 2018 are likely to recede somewhat, adding further to our expectation the US Dollar advance will abate. One of the most important of these factors has been global geopolitical uncertainty, both from within US political circles, but also globally. While US trade restrictions are putting considerable strain on the Chinese economy, the Chinese authorities will support the economy and do what they can to dampen any impact of a US trade tariffs. Aggressive currency policy, credit easing or foreign policy could be destabilising. Yet, the Chinese authorities are likely to be cautious given the degree of real estate associated debt.



We'd also be mindful of dynamics that can help alleviate pressures on China from trade policy. As we said earlier, we think it's important for investors not to allow fear to overwhelm evidence of supportive economic and market dynamics. An example would be the fact that during the 2018, the relatively strong USD versus the Chinese Yuan has tended to blunt the immediate impact of tariffs on the Chinese economy. Additionally, there has been a degree of burden sharing of the trade issue by importers, producers, and consumers which has provided a cushion of sorts. So ultimately, particularly for 2H 2019, while an all-out trade war would be a clearly negative outcome, how it plays out ultimately will be subject to many competing forces, all of which are understood by Chinese authorities playing a very long game steering arguably the world's most dynamic economy. Diligent management of Chinese growth can only add support to an extension of the current economic expansion and solid platform for equity markets to continue to perform.

Lastly for the US dollar, without any obvious threat to global growth (we've already mentioned we do not expect a US recession), and absent any significant market scare that invokes a more severe market selloff, the so-called "safety trade" where global investors swiftly move funds back to the US, pushing up the US dollar would appear a low probability heading into 2019. We've already seen a large move higher in the USD during 2018 amid "safety trade" concerns held by markets, but by and large, we believe investors will seek higher returns outside the US, reducing demand for US dollars.

GLOBAL CAPITAL FLOWS IN AN EXTENDED BUSINESS CYCLE

These influences on markets tend to suggest to us that the 2019 outlook for global equity markets might be more positive than the consensus currently expects. Several broad trends that tend to define equity markets during extended business cycles include:

- Equities tend to outperform other most asset classes
- Cyclical typically outperform defensives
- Large cap performance dominates small cap performance

These dynamics are all representative of global capital flows supporting equities as global investors stay on the hunt for returns. That focus will also drive capital flows towards opportunities for recovery plays in markets where the economic and political environment returns somewhat to a more normal backdrop. An obvious candidate would of course be emerging markets, where 2018 saw some severe currency and equity market weakness. The outlook here is gradually turning more positive in that there are now the early signs that both internal and external balances are being restored, in part with the support of the IMF. Should this process continue, which is likely, EM equities should recover, and then potentially outperform relative to global equities as global investors rebalance towards exposure they are clearly underweight in now. Should US dollar strength abate as we expect, USD based investors who search globally for the best opportunities will benefit, and this dynamic is typically associated with large capital flows supporting of emerging markets, and more broadly equity markets in general.

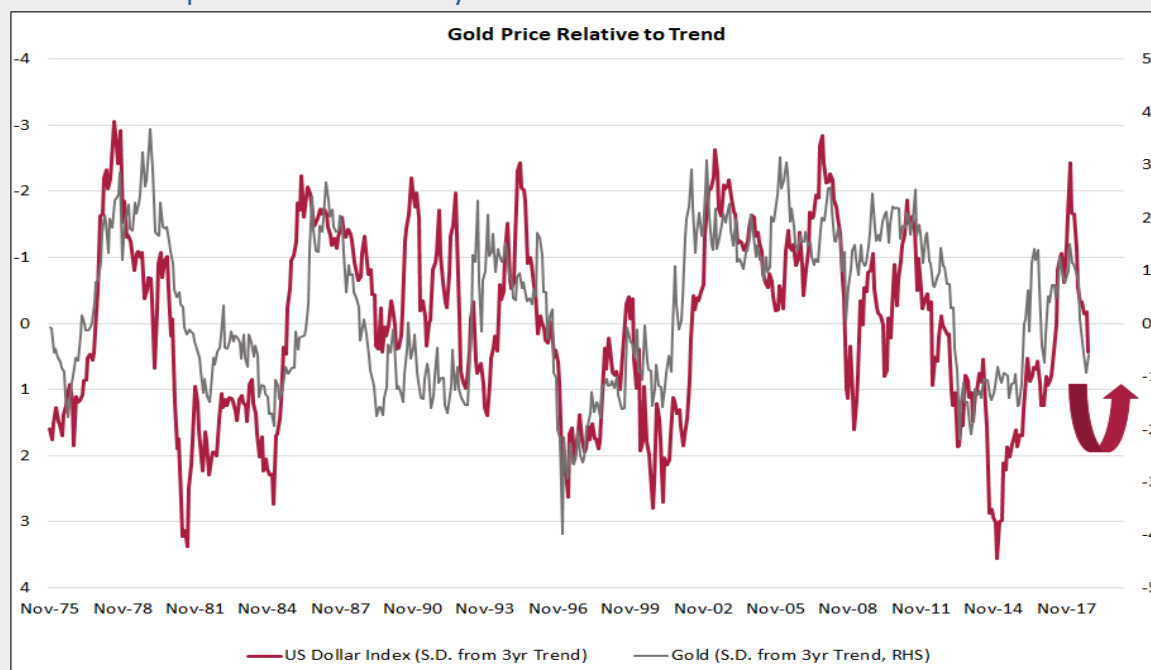
GOLD OUTLOOK: POSITIVE WITH SOLID SUPPORT

2018 has been a year that investors remember with some degree of pain understandably. This has driven many questions about our outlook for gold prices. While it's easy to be looking into 2019 with some trepidation, we believe gold prices will be determined less by fear and the perceived "store of value" argument than it will be driven by macro factors mentioned above, four of which we typically look at to model gold prices and form our outlook for gold and gold stocks. These include:

The more stable outlook for the US Dollar: movements in the USD are one of the main determinants of gold price trends. Chart 4 below shows the gold price in USD relative to its 3-year trend. Two things are very clear from the chart: 1) gold prices are very cyclical when compared to broad trends; and 2) gold moves in a very tight, but inverted relationship to the US dollar. Abating US dollar strength will help, and the potential for an actual decline in the US dollar would be very supportive of gold prices in 2019. This would be a strong platform for preferred gold stocks to perform well.



Chart 4: Gold prices move inversely to the USD around trends



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

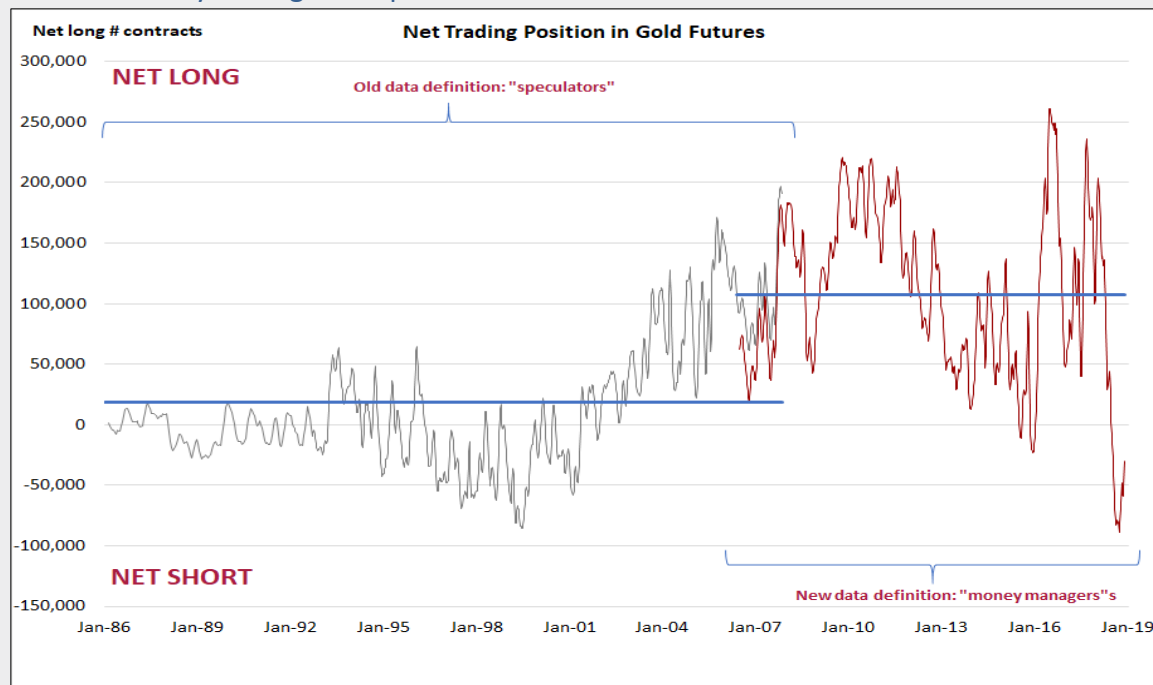
Inflation being maintained: The US Fed has maintained US inflation around their target of 2% and inflation trends appear benign heading into 2019. As we outlined earlier, this contributes to a more stable US dollar which would be a positive and supportive of gold prices making an orderly move higher.

Global investor sentiment and positioning in gold: another critical factor for gold prices is the positioning of market participants. Money managers that trade gold, along with ETF funds have become a significant force in the ebb and flow of demand for gold and tend to be far more dynamic than the much longer term commercial traders more interesting in hedging and positioning across much longer term production cycles. Chart 5 over the page shows the net position of the more speculative market participants which has a significant short term impact on gold prices. Currently, market participants are very short gold when looking back over the history and we believe this provides a significant support for gold prices in that it acts like a spring that is compressed, but ready to expand rapidly. Should more market participants also take the view that the USD strength will abate and gold looks set for a solid run into 2019, net buying in the gold futures market will likely move gold sharply higher.

Position in the business cycle: Similarly to our thoughts earlier, the global business cycle continues to operate at peak levels, but we're looking for an extended growth cycle, albeit at more moderate levels. We believe this supports gold as investors look to position portfolios for further down the road when growth does slow more.



Chart 5: Money manager net positions are the most “short” we have seen for a while.



Source: Commodity Futures Trading Corporation (CFTC), Fairmont Equities

SECTORS AND STOCKS TO CONSIDER

Our preferred portfolio positioning for 2019 consists of a 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, can maintain high margins, and are not overvalued for their premium product. Broadly, this approach can be broken down on a sectoral and thematic basis as follows. We prefer:

- Cyclical over defensives
- Large caps over small caps
- Select Resources and Energy
- Interest rate sensitive stocks
- Gold
- High Quality Growth



FOCUS STOCKS

The following are stocks on our watchlist for the time being, but this list will change over time:

BHP (BHP, large cap cyclical, POSITIVE):

Fundamental: We think the fact that BHP is trading at roughly the same level it was prior to the overall Australian stock market starting its slide over the past quarter speaks volumes about its 2019 prospects. This is an excellent performance. Prospects for recovery in energy prices, a more stable US dollar outlook (with possible weakness), and potential for an extended global growth backdrop are very supportive (see below under Fortescue Metals for iron ore commentary).

Technical: We target a push through overhead supply at around \$35 as a strong indication of likely follow through towards \$40.

Aristocrat Leisure (ALL, Premium Stock, POSITIVE):

Fundamental: We like the attractive earnings growth profile of ALL over the following three years, which we expect to positively surprise current market expectations. Earnings growth in FY19 and FY20 are expected to be underpinned by ongoing market share gains in the Americas division and the contribution to growth from the acquisitions in the Digital division and an improved growth path from 2020. We remain POSITIVE on ALL, trading on a very attractive 16.2x forward earnings.

Technical: ALL is an attractive proposition given the broader market is now trading below the major congestion area from 2016, prior to its advance in 2017. ALL is currently trading around the same levels as it did during the 2016 consolidation and looks very attractive should the broader market recover and rally.

CSL (CSL, Premium Stock, POSITIVE):

Technical: Valuations for CSL have improved with the market decline. CSL has been consolidating in a narrowing range over the past month and looks set to break out shortly. We'd look for CSL to outperform the market when the broader market recovers and look for a break above \$185 as a strong signal for follow through to \$195, but would target \$215 in a strong market in fairly short order.

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. Trading on a 1 year forward PE of 12.4, we consider this an 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 \$110 area and has shown some great strength on positive days. Any dip is a buying opportunity.

Fortescue Metals (FMG, Resources, POSITIVE)

Fundamental: FMG is the most leveraged China proxy of the large iron ore plays in Australia and its stock price is extremely closely correlated to iron ore prices. Chinese growth is expected to moderate in 2019 but remain at a very solid 6.6% according to the IMF. It now accounts for one-third of global growth. Chinese authorities will provide credit stimulus and RMD depreciation to cushion the blow from US tariffs.



Technical: For FMG to return to \$6 and above, we would need to see iron ore prices move back towards their 2017 mark at around USD87/dmtu, or almost 19% higher. That's unlikely in 2019. Yet, should news flow and the consensus on the Chinese growth outlook turn more positive, potential exists for FMG to move towards \$5 during 1H/2019, or a solid 19% move in the stock.

Santos (STO, Oil & Gas, POSITIVE):

Technical: We like the prospects for energy prices in 2019 and STO is typically an excellent stock to take advantage of that. Technically, we remain focused on finding a solid base for STO when energy prices trough and would be looking to buy any spring of a solid base consolidation. On longer term charts we note the \$5.00 level as a key support area to keep in mind given this was a major resistance level in 2016 for STO, and this subsequently provided a very strong base STO sprung from earlier this year.

Woodside Petroleum (WPL, Oil & Gas, POSITIVE)

Technical: Similarly, to STO above, we remain focused on isolating a solid base for WPL to buy into energy price strength once a solid trough has been set.

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 has hit overhead supply selling at \$16 and retreated marginally yet remains attractive.

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: From a technical perspective GMG has traded particularly solidly versus the market and has shown excellent follow-on after its recent range breakout. It has held its gains very well and continues to outperform. Another element of strength for GMG in portfolios is its excellent defensive technical qualities. During the weakness in the stock market over the past quarter, on days the broad equity market was down, it averaged a 0.74% decline. On those same days, GMG held in particularly well and declined only an average 0.2%, which is just under a quarter of the markets average decline. This is a particularly defensive stock given the quality of its business and a very powerful argument for investing in it.

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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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