Outlook for the Australian Share Market

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Topics covered

- How we started the year
- Why have markets rallied until now?
- Global economic outlook
- Outlook for commodities
- Outlook for global equity markets
- Outlook for the Australian share market
- How to handle reporting season
- How we are investing for our clients
- Q&A – What else would you like to know?

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About us

Fairmont Equities is a share advisory firm helping clients achieve higher returns from their share portfolios by combining both fundamental and technical analysis.

Michael Gable (Managing Director)

- Founded Fairmont Equities in 2013.
- Over 15 years in Financial Services, worked for companies such as Macquarie Bank.
- Bachelor Engineering (Hons), Bachelor Commerce, Dip Fin Services, Dip ML, ADA Levels 1 & 2

Gordon Anderson (Portfolio Manager)

- Former hedge fund trader and manager with Basis Capital, Rand Merchant Bank, Visor Capital
- Portfolio strategist for family offices and HNW investors at Morgan Stanley.
- Bachelor Economics, Bachelor Applied Science.

We are featured in:

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How we started the year

- In the last quarter of 2018, markets were collapsing.
- Fears revolved around rising bond yields, trade wars, etc.
- We sent out a strategy piece in the week leading up to Christmas titled “Equities Roadmap for 2019”.
- The main points were:

    1. US Federal Reserve policy would be a tailwind.
    2. Growth looks fine, inflation is benign.
    3. US dollar should weaken.
    4. Cyclicals will outperform defensives, large caps will outperform small caps.
    5. Gold prices will rise, even as share markets head higher.

1. US Federal Reserve

- We were looking for a pause in US interest rate rises.
- This is because rate rises are typically made to avoid overheating of the economy.
- This makes share market valuations look more attractive.

2. Growth is fine, inflation benign

- Slowing growth, but not too low.
- Rate rises to kill inflation end up killing the bull market in shares.
- Lower than expected inflation, means no need to raise rates.

3. Weaker US dollar

- Differences in central bank actions should narrow.
- This should put a lid on surges in the US dollar.

4. Buy cyclicals and large caps

- Lower interest rates and sustainable growth is good for cyclicals.

- When markets are “late cycle”, large funds tend to shy away from small caps due to liquidity issues.

- Stocks we invested in include:

  - ALL
  - BHP
  - CSL
  - APX
  - FMG
  - WPL
  - NCM
  - STO

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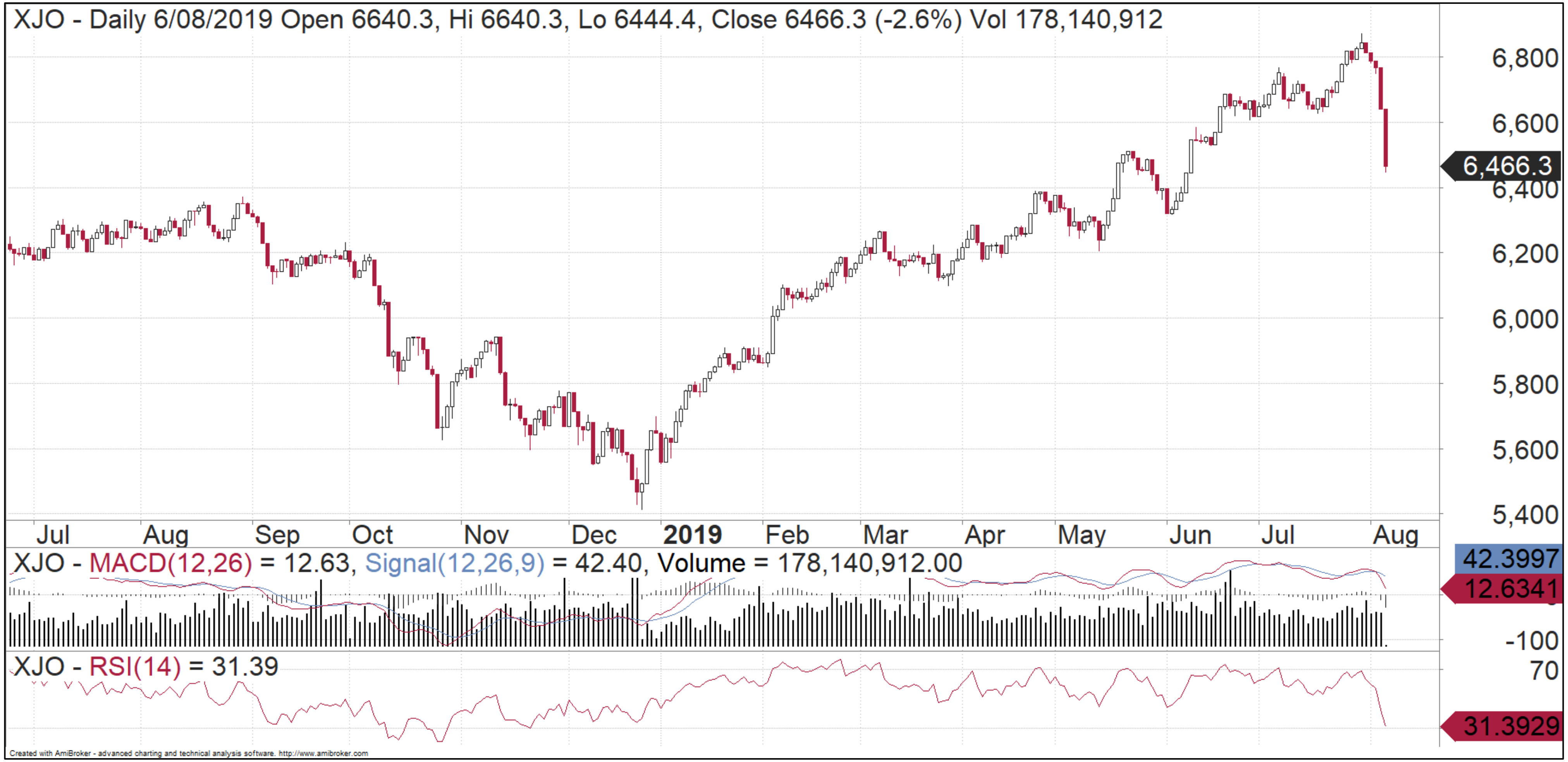
S&P/ASX 200



Source: *AmiBroker*

5. Gold prices should head higher

- In the short term, gold prices can move on fear.
- Biggest driver in the gold price is actually the US dollar (inversely related).
- Global sentiment too bearish with record levels of short positions in gold.

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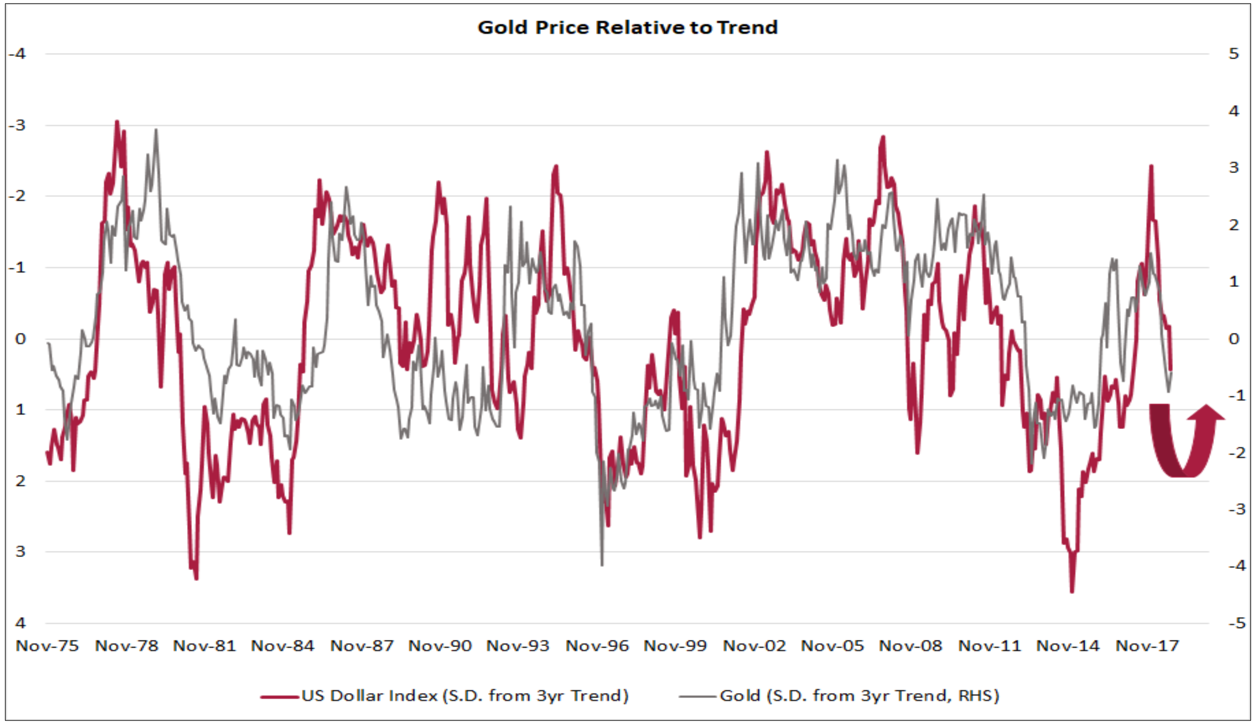
5. Gold prices should head higher

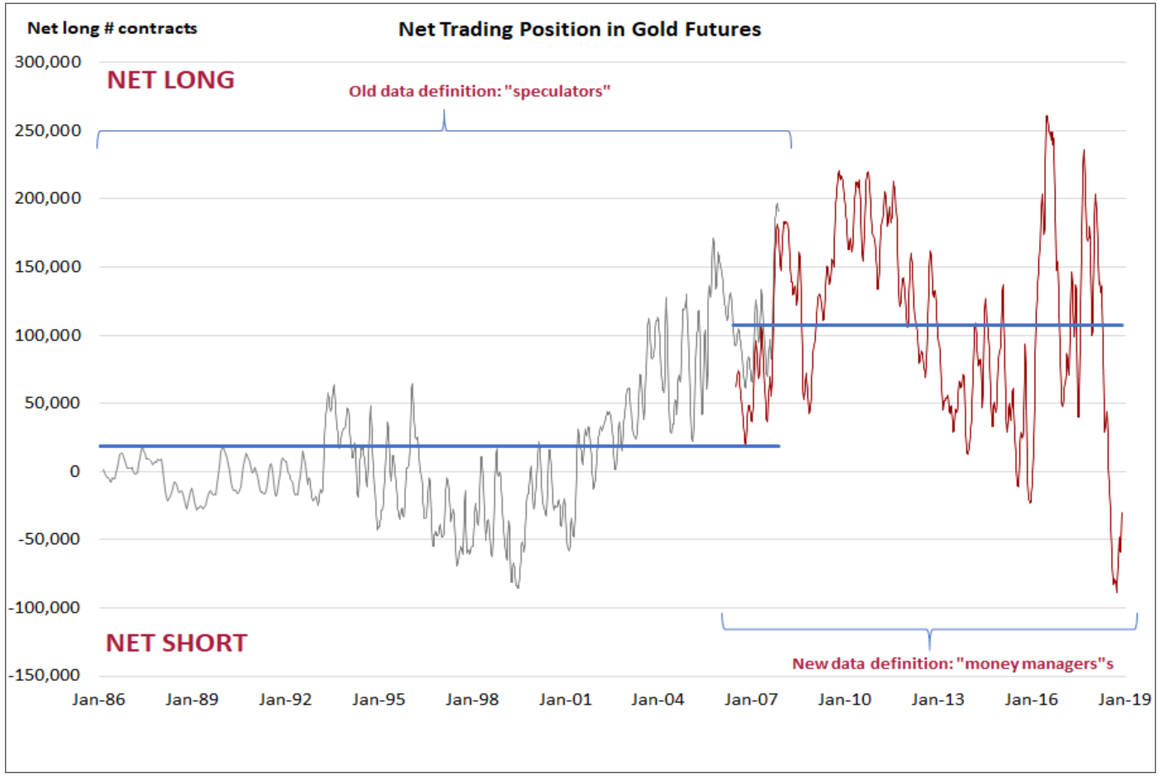
Gold price relative to the USD



Source: *CFTC, Federal Reserve of St. Louis, Fairmont Equities*

5. Gold prices should head higher

Money manager net positions



Source: *CFTC, Fairmont Equities*

Newcrest Mining (ASX:NCM) Weekly Chart

Source: *AmiBroker*

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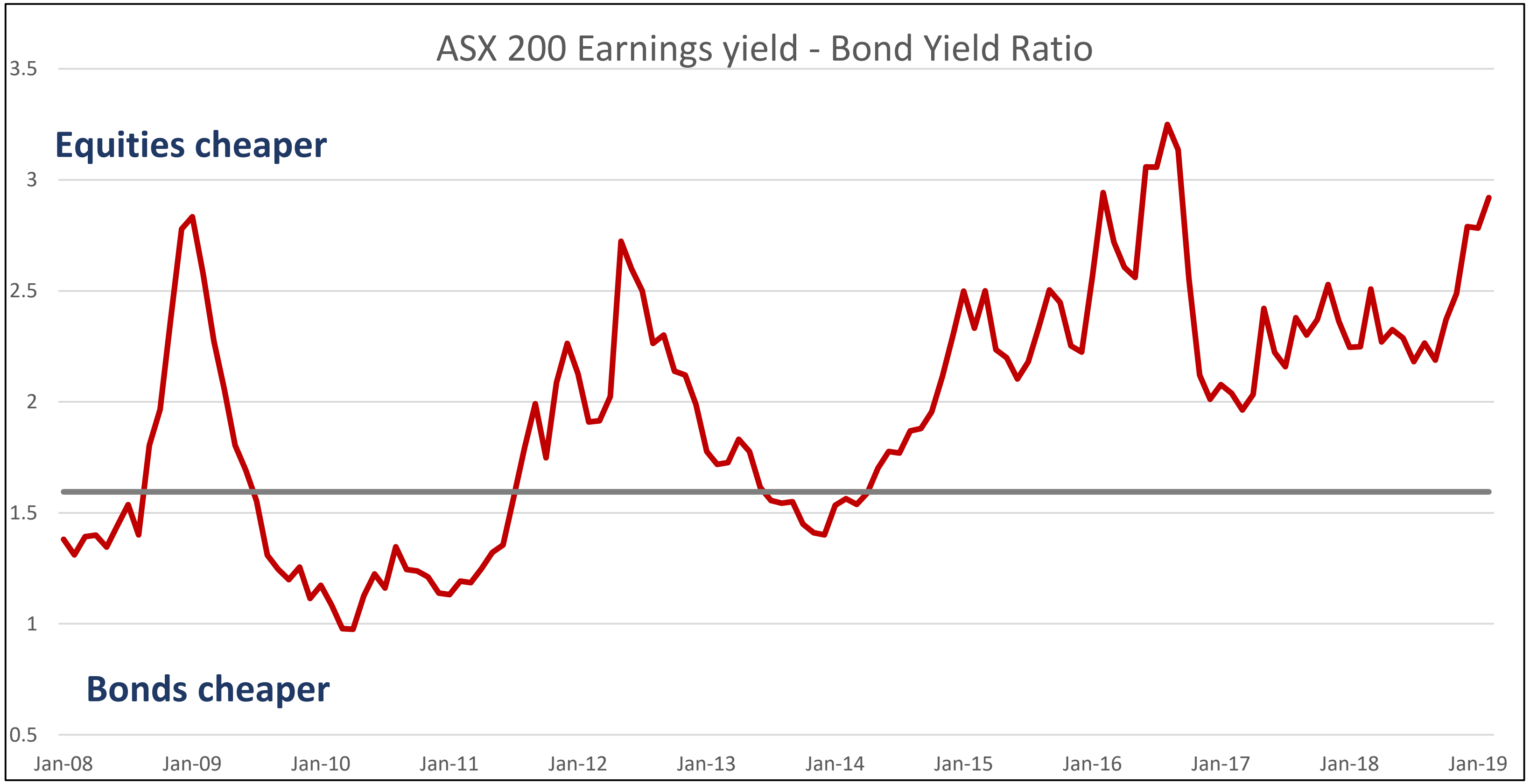
Why have markets rallied until now?

Market Valuations

- Equity valuations were at very attractive levels relative to bonds
- The earnings yield – bond yield ratio had only been cheaper in 2016.
- This provides a very good platform for equities to outperform bonds in 2019.



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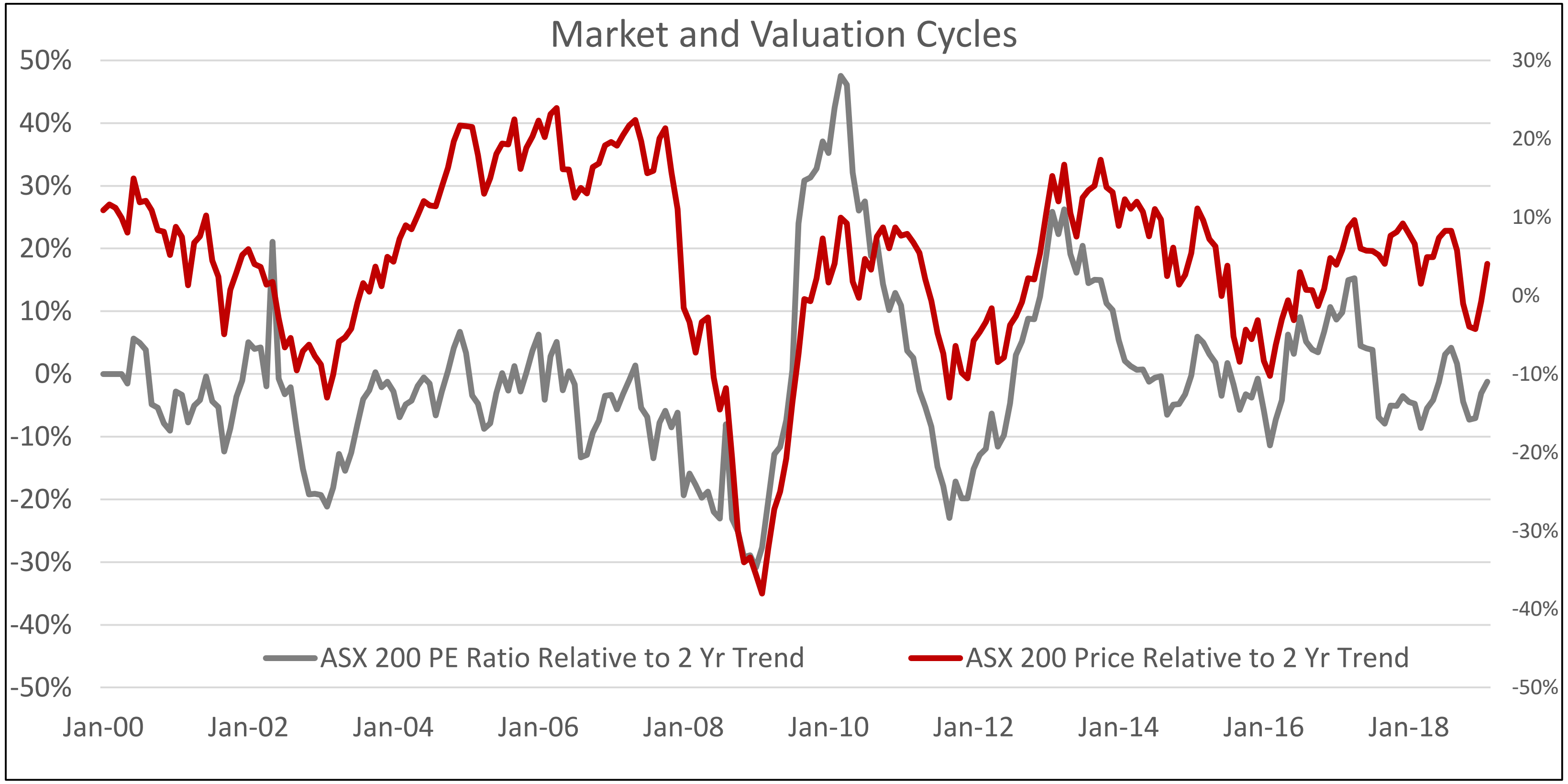
Market and Valuation Cycles

- Equity market valuations are cyclical, just like the underlying index

- Valuations were roughly as attractive as they were in 2016 when compared to their 2 year trend

- With an extended cycle and rates to remain low valuations and markets look solid for the remainder in 2019



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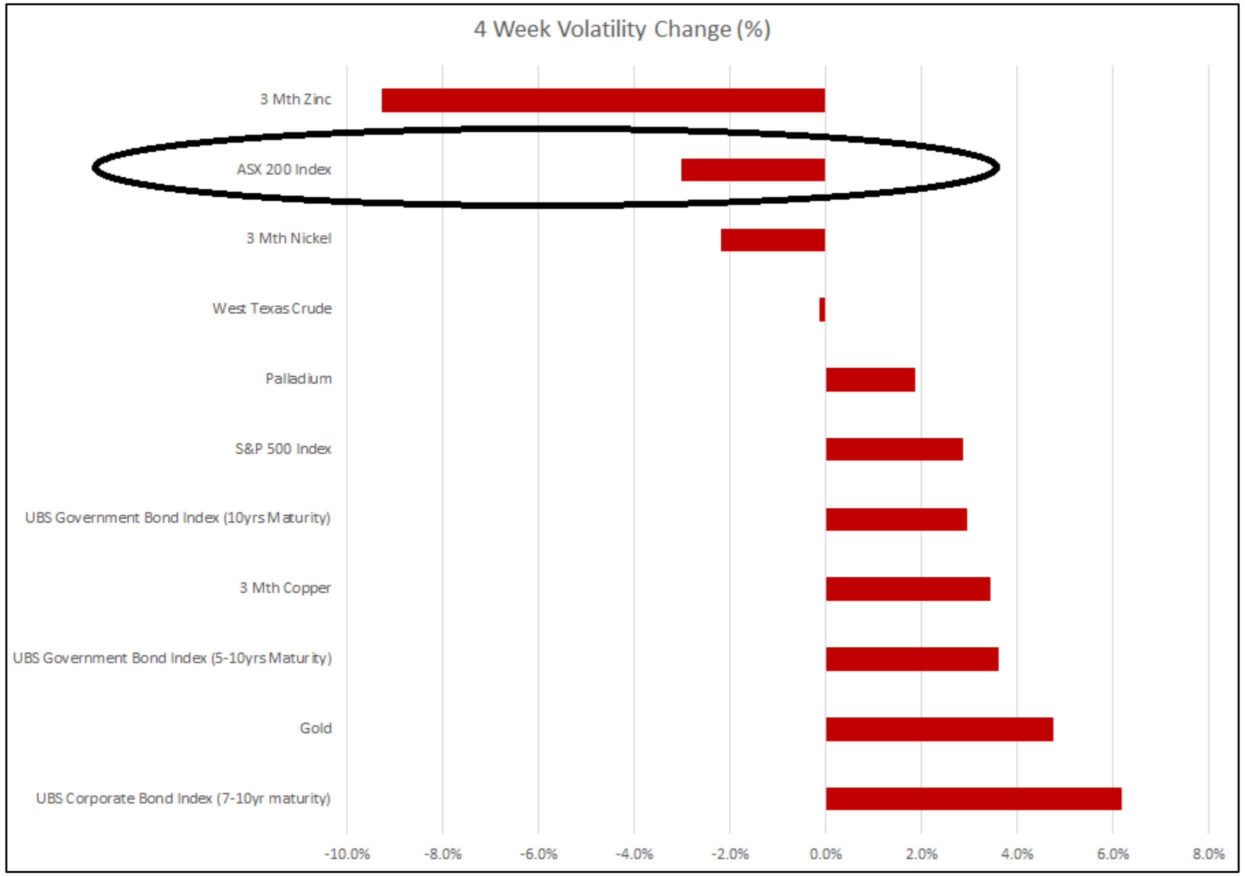
Volatility

- The bond market has been hypersensitive to the global growth outlook

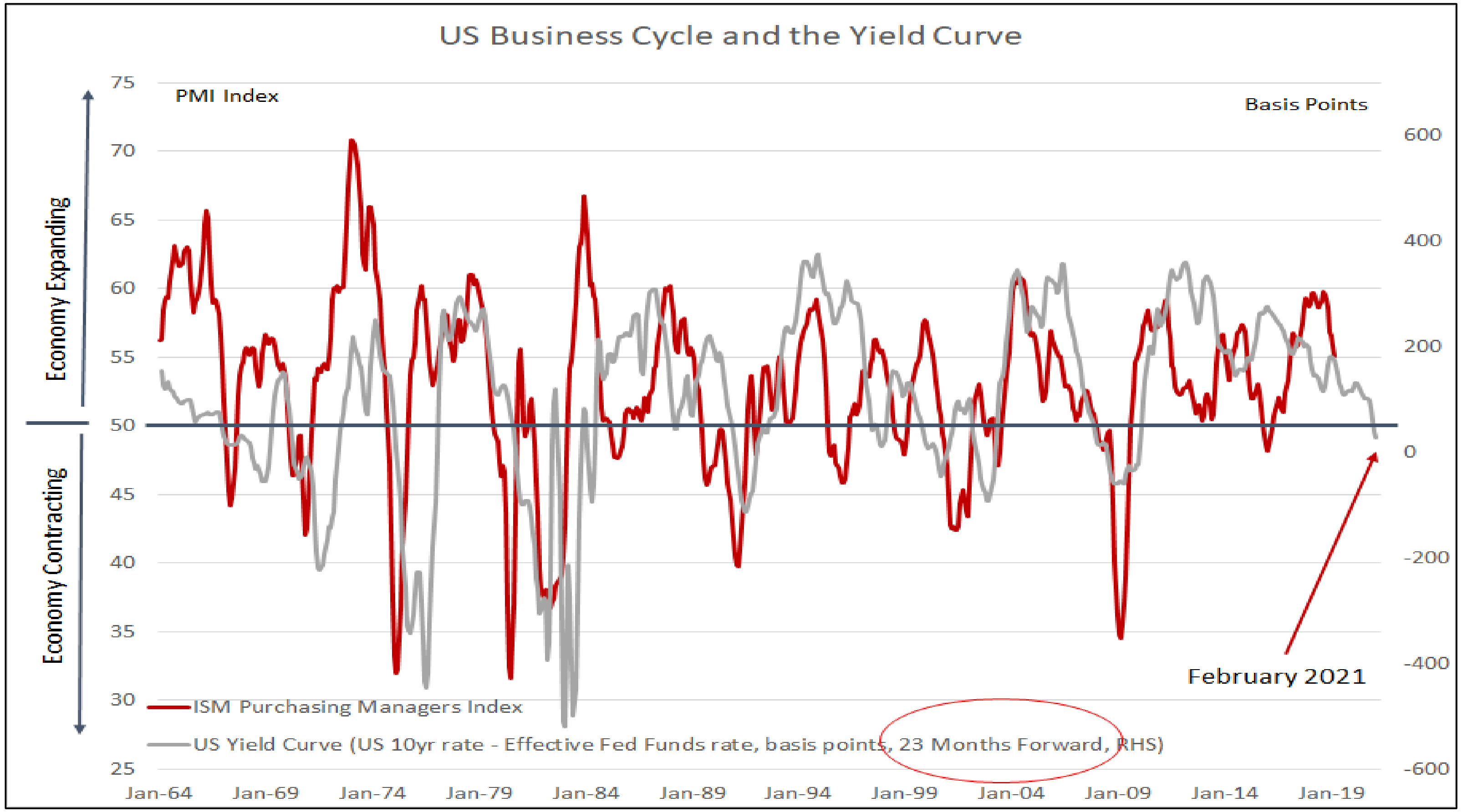
- So while equity markets are more volatile than bond markets generally, bond market volatility rose more than equity market volatility in 1Q19

- Global metals markets remain sensitive to changes in the global growth outlook.



US Yield Curve – March 2019

- The US yield curve has a history of indicating business cycles
- The efficacy of the US yield curve as a cycle indicator has been compromised by quantitative easing
- The typical lead time is 20-24 months
- Using the yield curve in isolation points to a growth contraction from February 2021

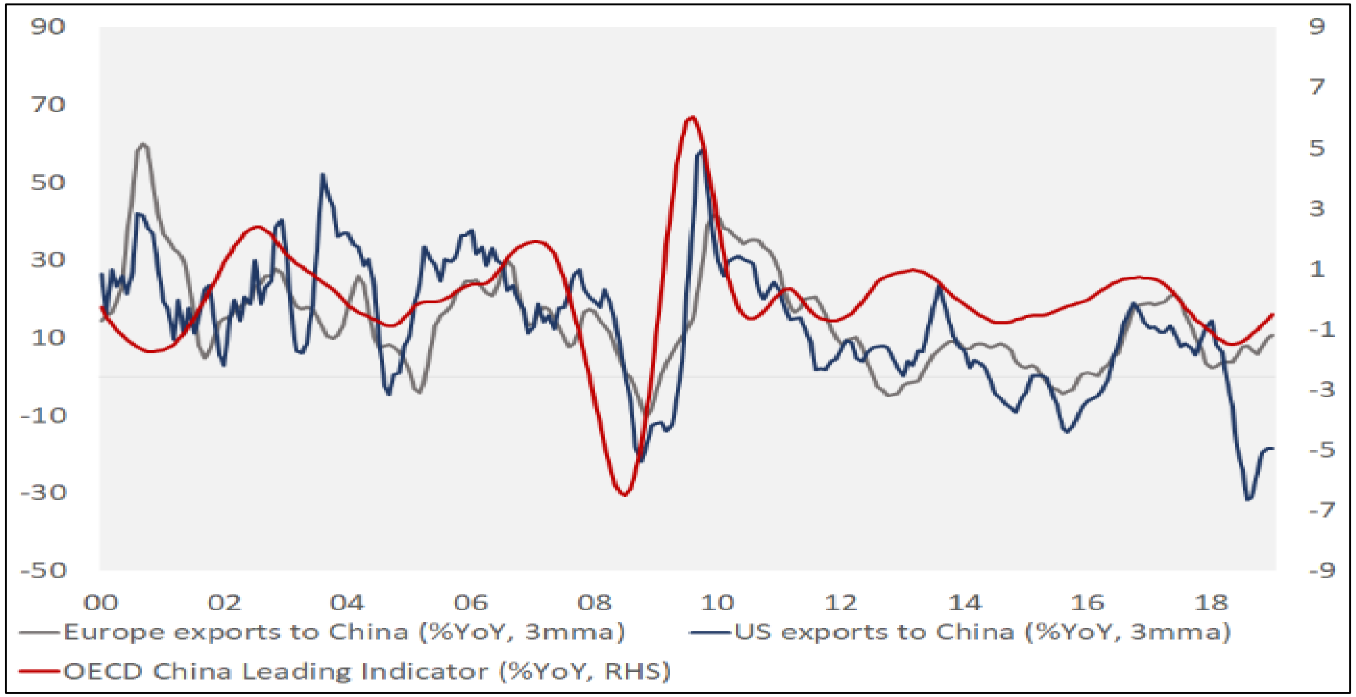


Global economic outlook

We are in a cyclical trough, not a recession

- Cycle indicators are potentially troughing
- Both US and European exports to China appear to have bottomed and the OECD China leading indicator is turning upwards.
- Central bank policy is now the key focus

OECD China LEI and exports from the US and Europe to China

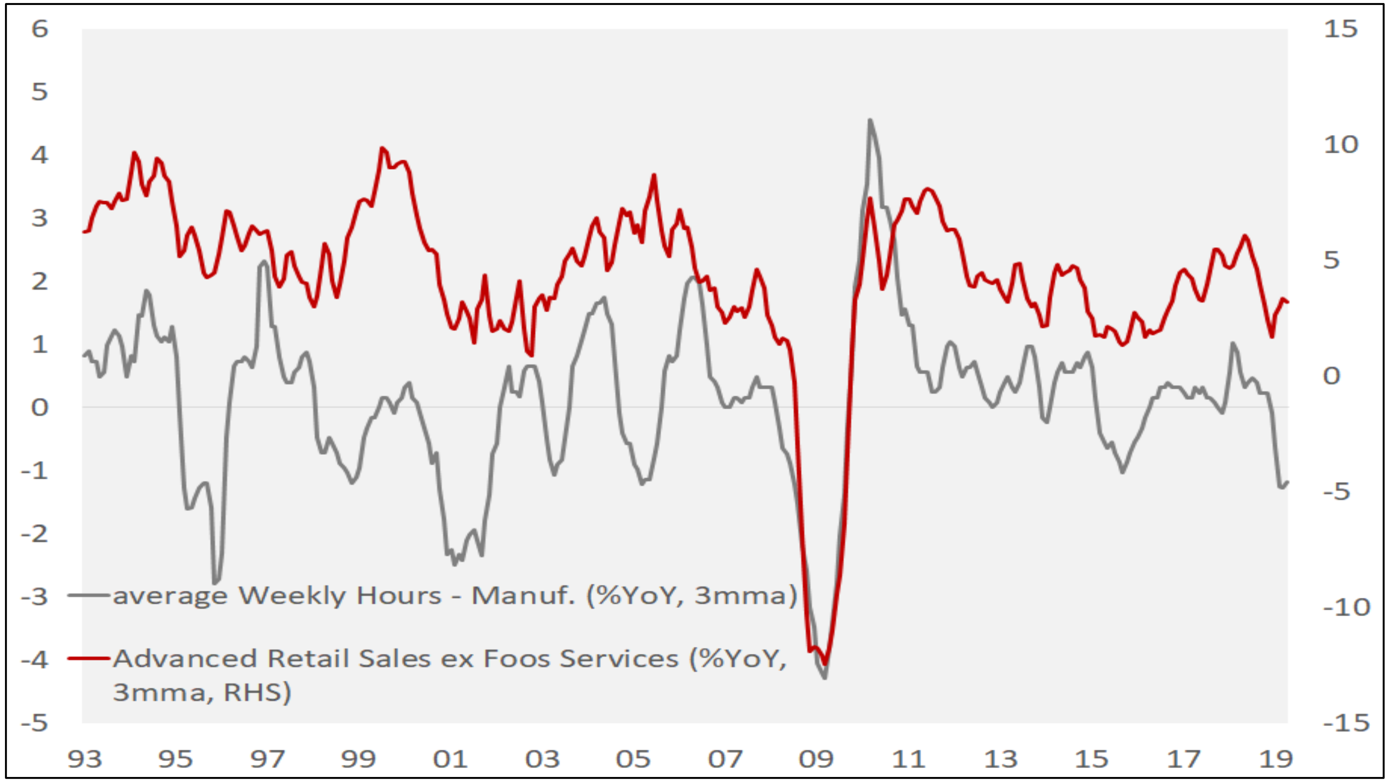


Source: Federal Reserve Bank of St Louis, ECB, Fairmont Equities

A 2016 style growth slowdown

- Consumer confidence in the US remains elevated
- Hours worked is a leading indicator, similar to positive reversals seen in 2016, 2005, 2003, and 1998
- This could lead to improved corporate profits next year

Troughing manufacturing hours



Source: Federal Reserve Bank of St Louis, Fairmont Equities

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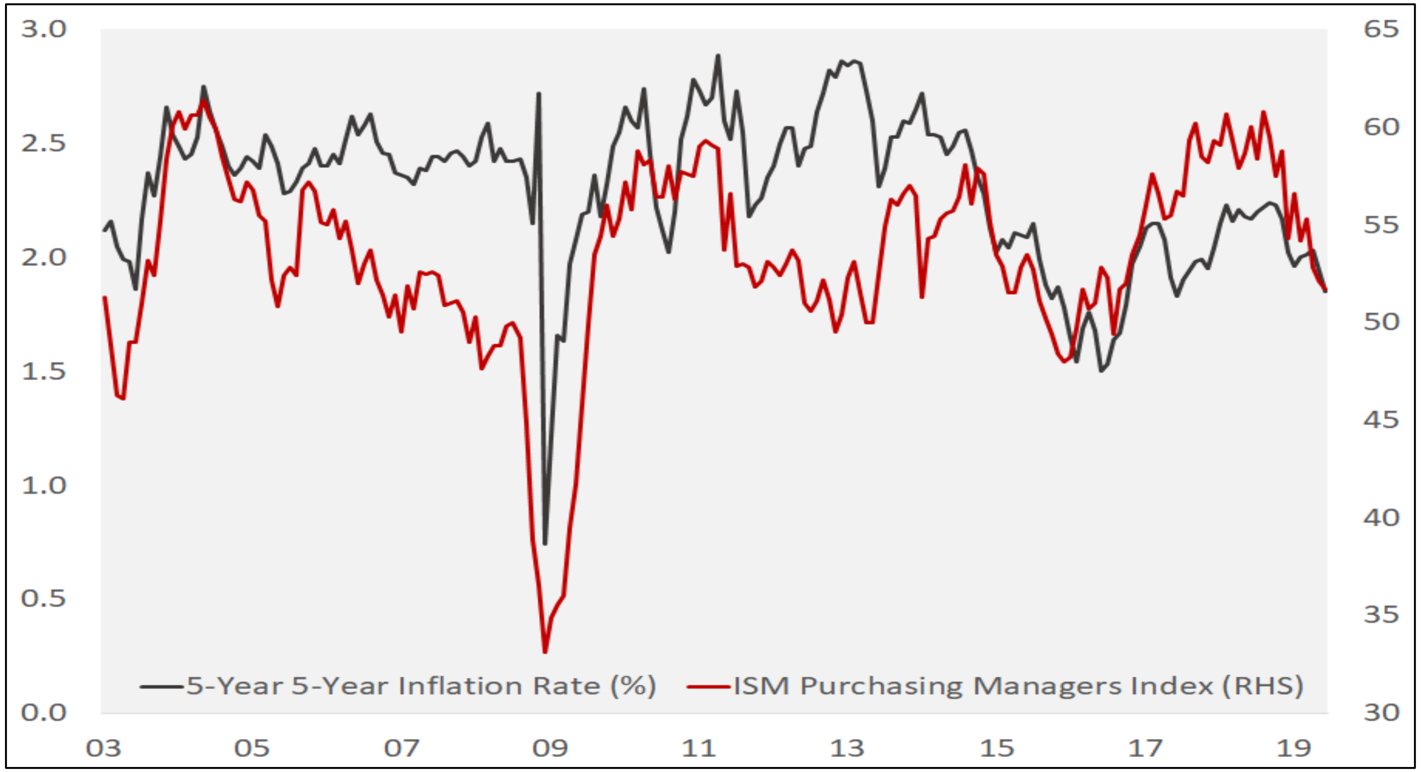
Inflation outlook is muted

- US bonds yields attractive compared to Europe
- Inflation expectations continue to come down
- US Corporates need inflation to assist activity
- Lower US rates will raise import inflation marginally

Fed needs to assist inflation

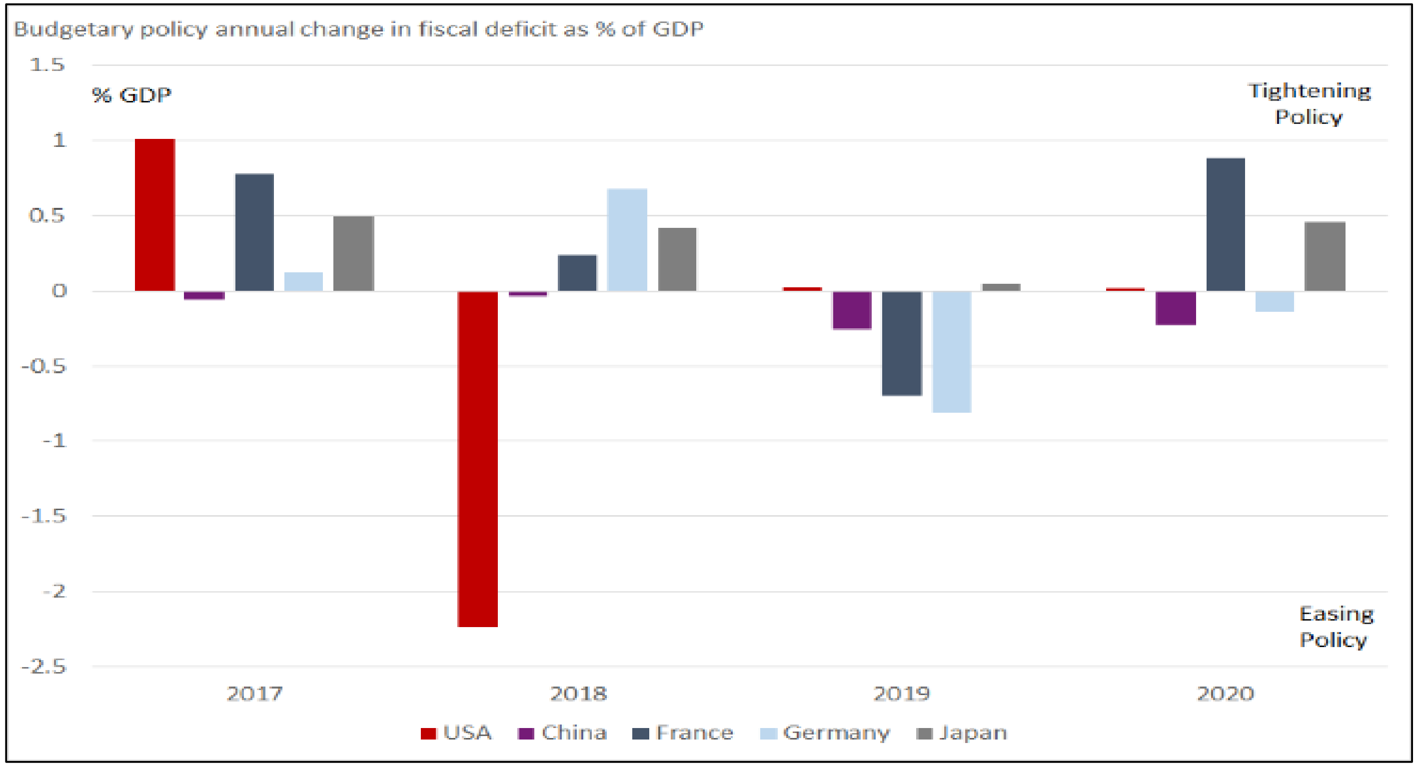


Source: Federal Reserve Bank of St Louis, Fairmont Equities

Global policy outlook

- Geopolitical risks threaten global outlook. US Fed needs to cut rates
- Rate cuts support risk assets but US Fed needs to be careful not to disappoint
- Expansionary fiscal policy is likely to augment monetary stimulus

Global budgetary policy likely to add support into 2020



Source: OECD, Fairmont Equities

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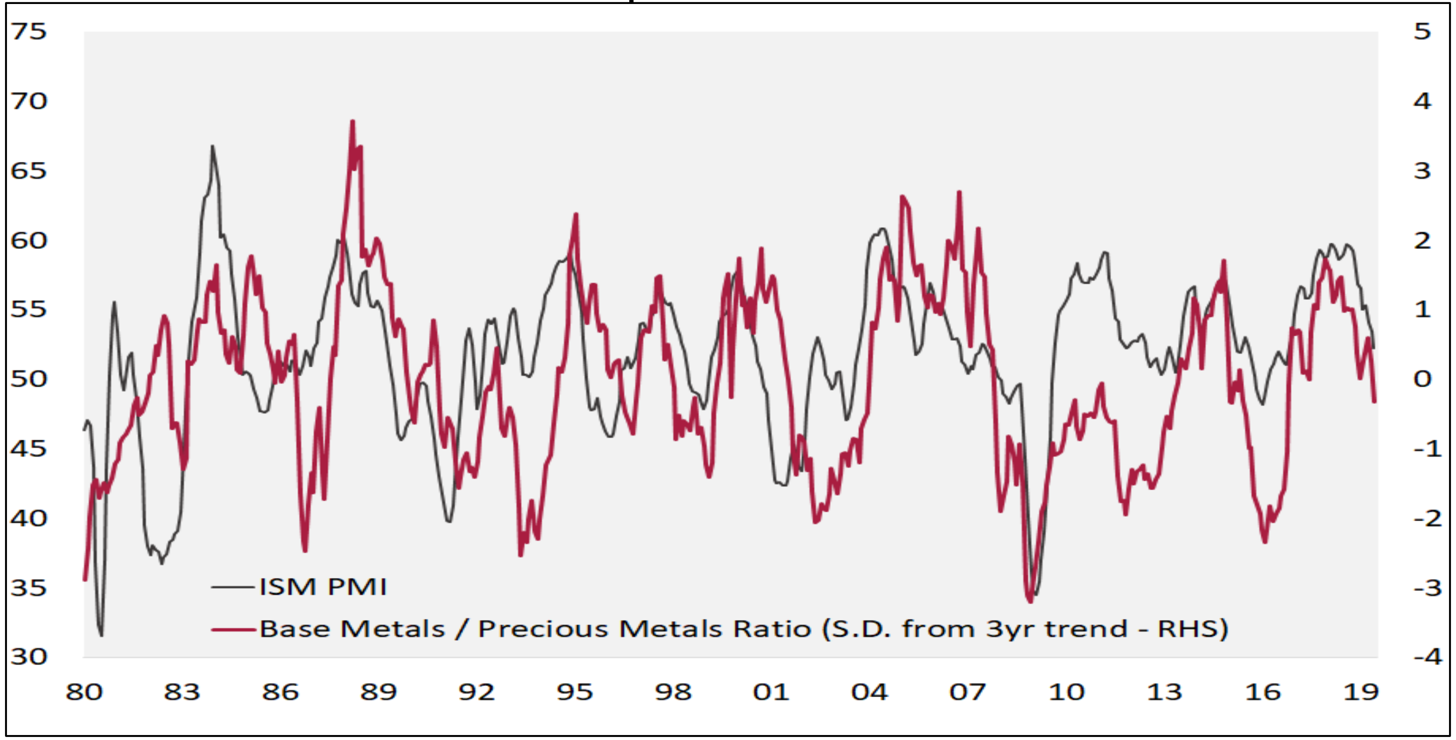
Commodity outlook

Growth outlook not supportive, yet

- Base metals to underperform precious metals. We still like gold
- Base metals positioning is net short. Look for a bottoming
- Oil prices not reacting well to risk events

Base metals / precious metals ratio

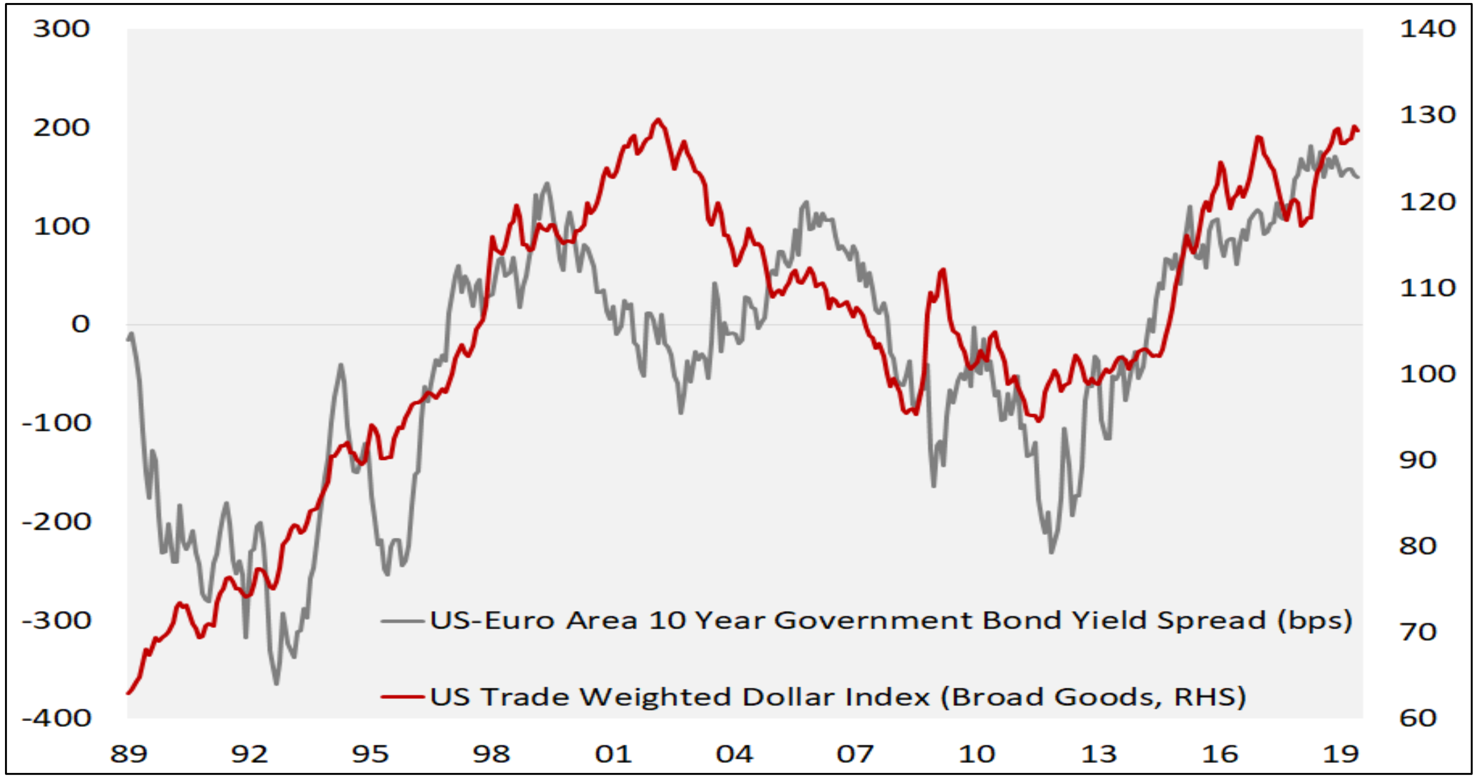


Source: World Bank, Fairmont Equities

Extension of business cycle is needed

- Central banks like to maintain low rates
- ECB is likely to drive rates lower
- Yield spread between US and Europe favours US
- Stronger US dollar would be unsupportive of commodity prices.

US – Euro area yield spread, supports US dollar, negative for commodities



Source: OECD, Fairmont Equities

Outlook for global equities

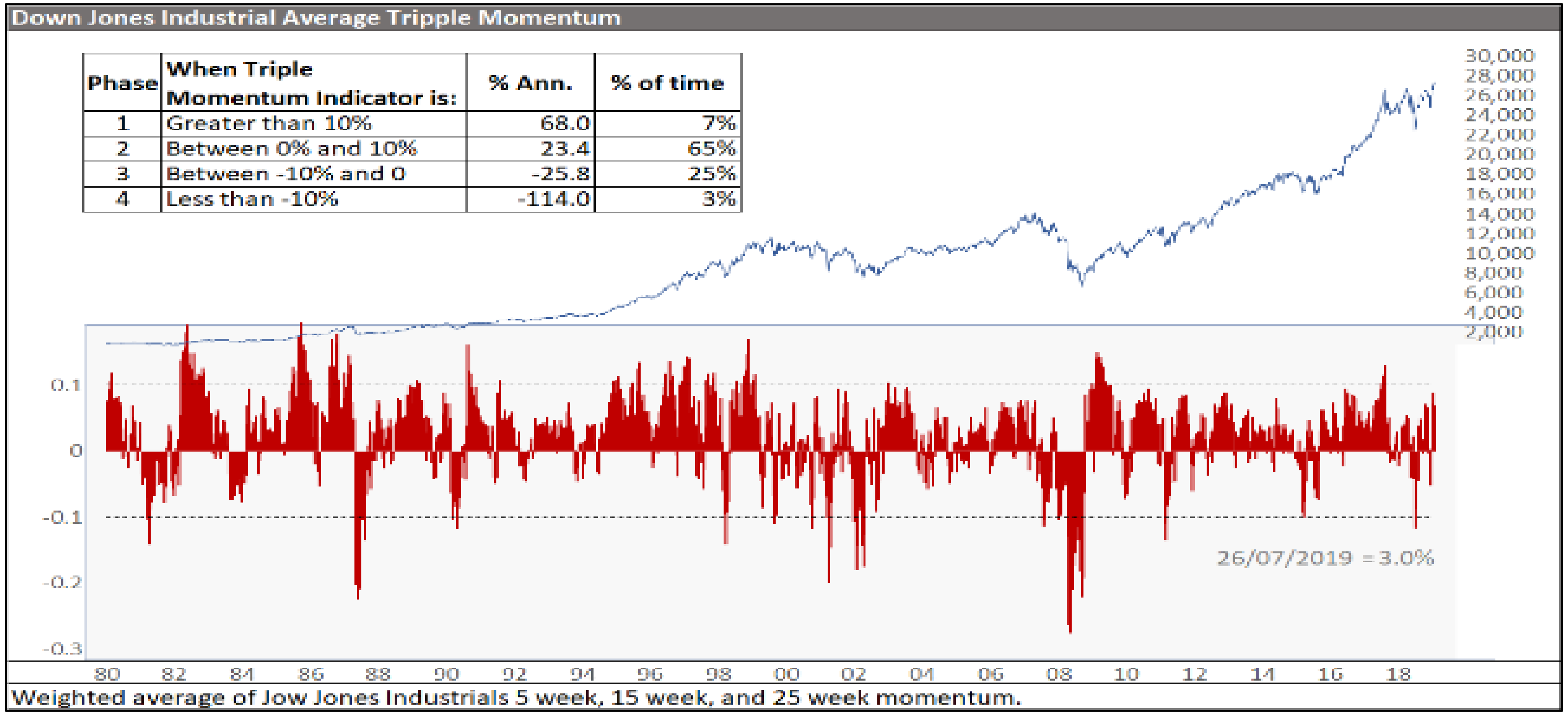
US equities to lead the way

- Rate cuts will support equities, for now. We are in phase 2 of Triple Momentum Model

- Basic materials weighed down by growth concerns and trade wars

- Potential for outperformance should improve as rate cuts flow through and cycle indicators trough

Triple momentum model supporting of further gains > 20%



Phase	When Triple Momentum Indicator is:	% Ann.	% of time
1	Greater than 10%	68.0	7%
2	Between 0% and 10%	23.4	65%
3	Between -10% and 0	-25.8	25%
4	Less than -10%	-114.0	3%

Source: IRESS, Fairmont Equities

Market pricing cyclical trough in early 2020

- Cyclical sectors such as Industrials are highly correlated to global growth
- US exports to China appears to have bottomed
- Global Industrials are outperforming equities
- Cyclical sectors pricing a trough in growth around 1Q/2020, not recession

Global cyclical sectors are already pricing in a growth trough

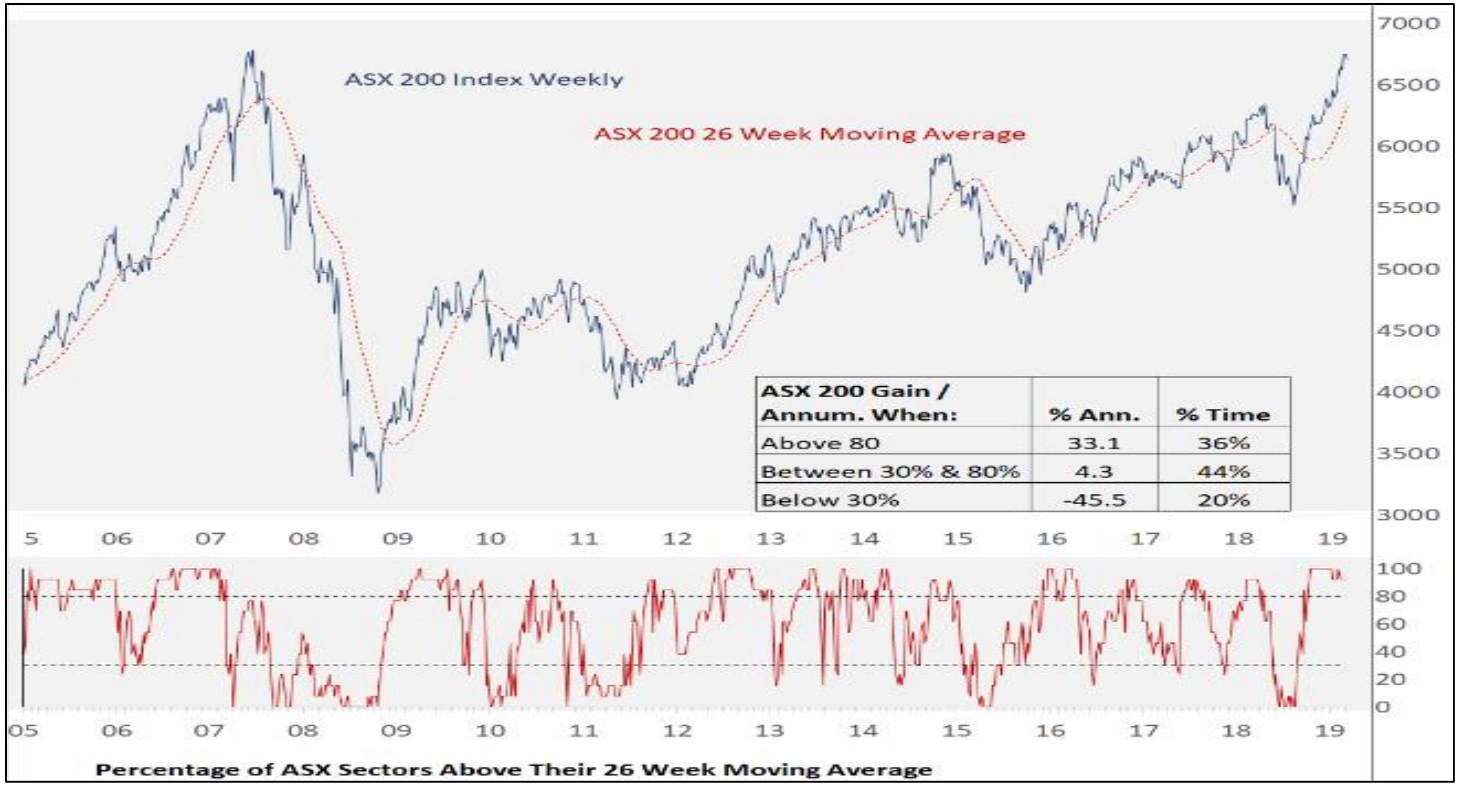
Source: Federal Reserve Bank of St Louis, Fairmont Equities

Outlook for Australian share market

Rally continues

- Our sector breadth model shows more than 80% of sectors trending well
- However, volatility has compressed and approaches lows, driving aggressing hedging
- Australian equity performance correlates closely with basic materials

ASX sector breadth model consistent with ongoing gains

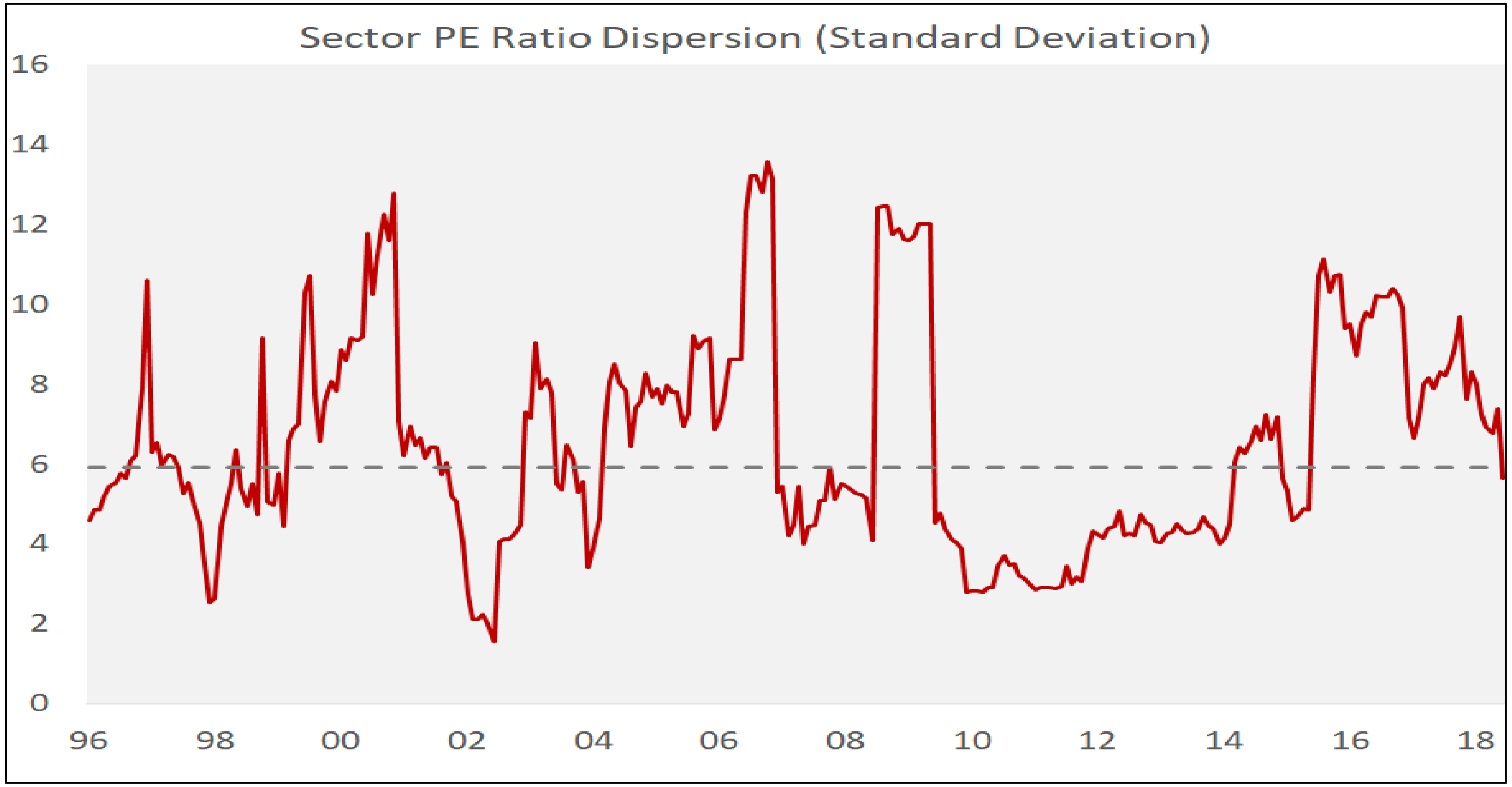


Source: CME, Fairmont Equities

Reporting season could be a risk

- Valuation multiples have expanded but reasonable compared to prior peaks
- Sector valuation dispersion has compressed to average levels
- This means that attractive valuations are at stock specific level

Sector valuation dispersion has compressed



Source: Federal Reserve Bank of St Louis, Fairmont Equities

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Reporting season

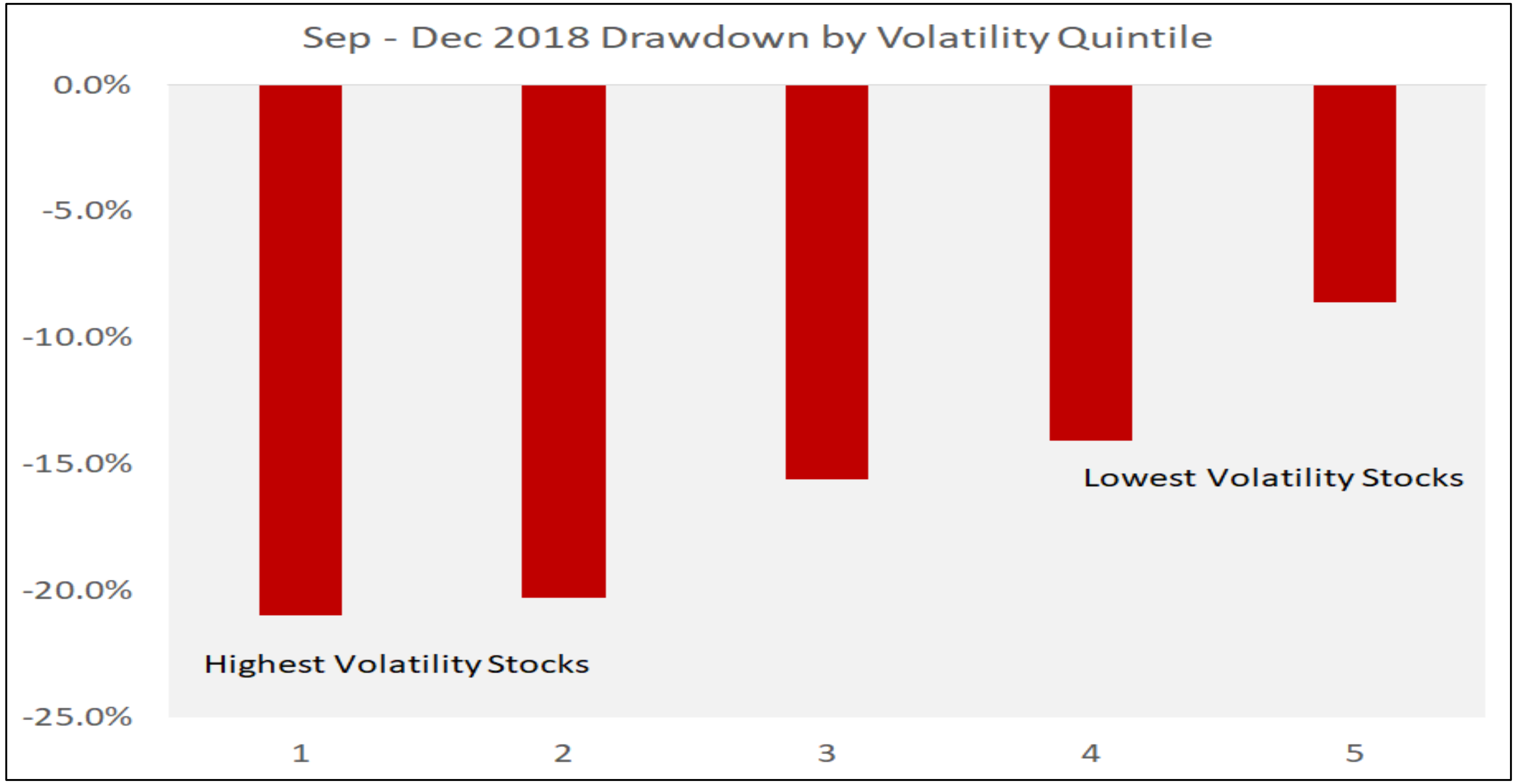
Selectively cautious

- Reporting season brings singe-stock volatility risk

Stocks most at risk of adverse price reactions to report:

- Stocks outperforming into results
- Those with premium valuations
- Higher than market volatility

High volatility stocks should be treated with caution



Source: IRESS, Fairmont Equities

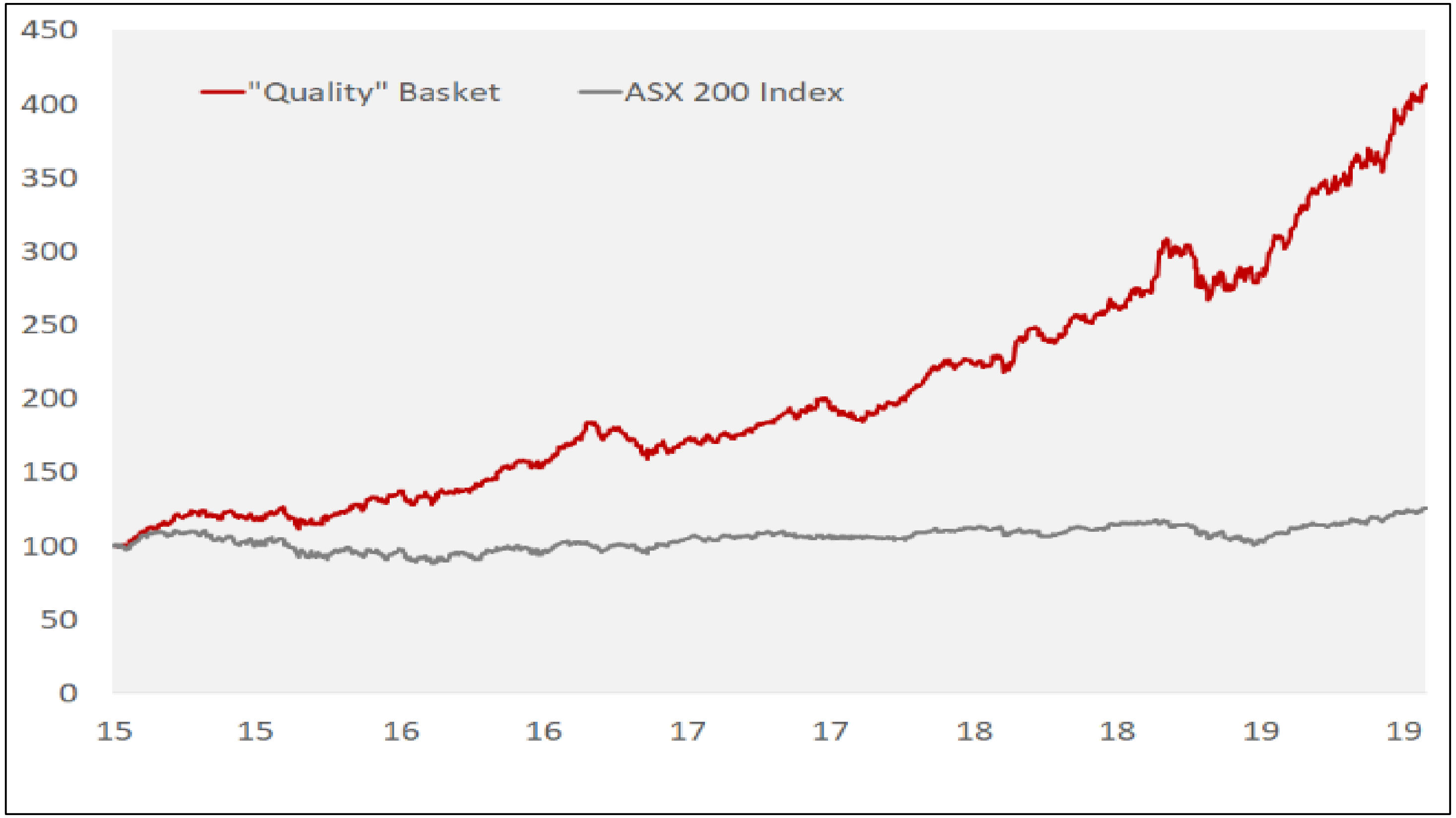
Core portfolio

- Maintain a "core" part of your portfolio.

Criteria should include, but not limited to:

- Best in industry business
- Highest franchise value
- High quality management
- High profitability and margins
- Strong balance sheet
- Stable share price volatility profile

Our core stocks, if bought back in 2015, outperformed the market



Source: IRESS, Fairmont Equities

How we are investing for our clients

- Understand the overall macro environment.
- Look for companies that are fundamentally strong.
- Combine that with technical analysis to filter out those that are trading the best.
- Once we select a company, we put it into a bucket of either a “core holding” or a “trade”.
- Core holdings tend to be high quality companies with defensive characteristics. We can tolerate a bit more downside on these.
- For the other stocks, we run a trailing stop level to tell us when to cut our losses.

How we deal with an open position

- Our philosophy is to let a position run for as long as it is heading in the right direction.
- We utilise trailing stops to alert us if we need make a decision to get out.
- Trailing stops are generally a combination of the 10-day low, 3 ATR, nearest support.
- When the market is looking weak, we virtually cease buying anything new.
- Our preference is not hold a position if it is underperforming the market on a relative basis.

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Questions

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